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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

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Annual Compliance Report, 2011	)	Docket No. ACR2011
	)	

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
INITIAL COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2011 ANNUAL COMPLIANCE REPORT**
(February 3, 2012)

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INTRODUCTION

On December 29, 2011, the Postal Service filed its "United States Postal Service FY 2011 Annual Compliance Report" ("ACR"), which is required by 39 U.S.C. section 3652(a) to be filed within 90 days after the end of each fiscal year. On January 3, 2012, the Postal Regulatory Commission ("Commission") issued Order No. 1095, "Notice of Postal Service's Filing of Annual Compliance Report and Request for Public Comments," seeking initial comments by February 3, 2012, and reply comments by February 17, 2012. The Commission's Annual Compliance Determination ("ACD") is expected in late March 2012.

Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") hereby submit these joint initial comments in response to the Commission's Notice.

COURSE OF PROCEEDINGS

The Commission issued Order No. 1095, commencing proceedings in this docket, and inviting:

> public comment on the Postal Service's FY 2011 ACR and on whether any rates or fees in effect during FY 2011 (for products individually or collectively) were **not in compliance** with applicable provisions of chapter 36 of title 39 (or regulations promulgated thereunder). Commenters addressing market dominant products are referred in particular to the applicable **requirements** (39 U.S.C. 3622(d) and (e) and 3626); **objectives** (39 U.S.C. 3622(b)); and **factors** (39 U.S.C. 3622(c))....
>
> The Commission also invites public comment on the **cost coverage matters the Postal Service addresses in its filing**; service performance results; levels of customer satisfaction achieved; progress toward goals established in the annual Comprehensive Statement; and such other matters that may be relevant to the Commission's review. Comments on these topics will, *inter alia*, assist the Commission in developing appropriate recommendations to the Postal Service related to the protection or promotion of the public policy objectives of title 39. [Order No. 1095, p. 5 (emphasis added).]

On January 30, 2012, Valpak filed a Motion for Issuance of Information Request, seeking additional information related to the cost coverage and contribution from Standard Mail products and Every Door Direct Mail. On January 31, 2012, the Commission incorporated Valpak's requests in Chairman's Information Request ("ChIR") No. 2. *See* ChIR No. 2, questions 1 and 2.

I. PAEA'S REQUIREMENT THAT THE POSTAL SERVICE PREFUND THE RETIREE HEALTH BENEFIT FUND AT THE RATE REQUIRED ON TOP OF OTHER CHALLENGES HAS DECIMATED POSTAL SERVICE FINANCES REQUIRING CONGRESSIONAL RELIEF AND COST REDUCTIONS.

A. In FY 2011, the Postal Service Suffered a Net Operating Loss of $4.9 Billion, Reflecting an Acceleration in the Bottom Line's Downward Trend.

The Postal Service's financial condition was so dire at the end of FY 2011 that Congressional remedial action **will be required** before the end of FY 2012.

Unfortunately, the source of this financial crisis often is misunderstood. Press and Congressional attention too often focus on the Postal Service's **gross loss.** That reported loss includes a special unique burden which Congress imposed on the Postal Service — namely, payments into the Postal Service Retiree Health Benefits Fund ("RHBF") to **pre-fund** health care benefits for **future** retirees, as mandated by the Postal Accountability and Enhancement Act ("PAEA"). The aggressive pre-funding requirement has put an unbearable strain on Postal Service finances.

Real understanding of the Postal Service's finances and evaluation of its business model requires focus on Postal Service **operating profit and loss**, based on its revenues and expenditures for operations, which is where this analysis begins. Table I-1, *infra*, shows Postal Service operating revenues and operating expenses for five years, FY 2007 through FY 2011, all years since enactment of PAEA.

In Table I-1, the first row shows operating revenues, which are derived from mailers, except for a few small items. The second row shows all expenses for operations, **except costs of health benefits.** Payments for health insurance premiums for **current retirees,** which always have been recorded as an operating expense, are shown separately on row 4. The net

profit or loss from **operations** is shown on row 5. Funds set aside to **pre-pay** health benefits for **future retirees** — *i.e.*, payments to the RHBF — which are not essential for current operations, are shown separately on row 6.[1] Amounts shown on row 6 reflect abatements allowed by Congress in FY 2009 and FY 2011. Thus, the results reported each year include the following two components, which should be viewed separately:

- the profit or loss from operations, referred to in these comments as the "**operating profit (loss)**," on row 5, and
- the PAEA-required contribution to the RHBF, on row 6.

The *FY 2011 Comprehensive Statement on Postal Operations* likewise focuses on financial results from operations:

> Our fundamental goal is to generate **income sufficient to fully fund operations** and invest in improvements for the future. [*Id.*, p. 34, emphasis added.]

Table I-1 reveals that during the **first four years** under PAEA the Postal Service actually had a **cumulative operating net income,** or operating "profit," of $0.6 billion, but viewed over a **five-year period** the **cumulative operating loss** was $4.3 billion.

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[1] Prior to PAEA, the Postal Service funded retiree health care costs on a **current** basis, but did not **prepay future** costs. The Postal Service's financial statements are required by generally accepted accounting principles ("GAAP") to include contributions to the RHBF as operating expenses because those outlays are statutorily-mandated by PAEA.

Table I-1
Postal Service Operating Revenue and Expenses
FY 2007 – FY 20101
($, millions)

	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
1. Operating Revenue	74,778	74,932	68,090	67,052	65,711
2. Operating Expenses, excluding Retiree Health Benefits	70,021	70,331	68,440	67,679	68,193
3. Operating Profit (Loss) Before Retiree Health Benefits	**4,757**	**4,601**	**(350)**	**(627)**	**(2,482)**
4. Health Benefits for Current Retirees	1,726	1,807	1,990	2,247	2,441
5. Net Operating Profit (Loss), excluding RHBF	**3,031**	**2,794**	**(2,340)**	**(2,874)**	**(4,923)**
6. Funding of RHBF	8,358	5,600	1,400	5,500	------
7. Five-year net **operating loss**, excluding RHBF					4,312
8. Five-year cost of RHBF					**20,858**
9. Five-year total **reported loss**					25,170

Sources: 2011 Form 10-K Report, pp. 80 and 89 (Note 7), and 2009 Form 10-K Report, pp. 63 and 71.

When the required RHBF contribution is taken into account, even in the best year, FY 2007, profit from operations was far from sufficient. The five-year cumulative result was an operating loss of $4,312 million (row 7). This means that over the five-year period, operating profits from which to make any payments to the RHBF were nonexistent, despite abatements provided by Congress in FY 2009 and FY 2011. Cumulative results for the five years under PAEA are summarized at the bottom of Table I-1, on rows 7-9. Of the total reported cumulative loss of $25,170 million, over 80 percent was attributable to payments to the RHBF.

Starting in FY 2008, the economy, mailers, and the Postal Service fell victim to what has been called the Great Recession.[2] That recession was responsible for accelerating the decline in the volume of First-Class Mail,[3] which was accompanied by an unprecedented decline in total revenues: $6.8 billion in FY 2009, followed by a further decline of $2.4 billion over the next two years. In response to the sharp falloff in volume and revenue, the Postal Service reduced operating expenses (*i.e.*, **excluding** all payments for health benefits for current and future retirees) by $2.7 billion (Table I-1, row 2).

In FY 2011, even as revenue continued declining, operating expenses — excluding health benefit costs (row 2) — increased. Health insurance premiums for current retirees (row 4) also increased. The result is the **operating loss of $4.9 billion** reported by the Postal Service in FY 2011, as shown in Table I-1, row 5. The Postal Service thus swung from an **operating profit of $3.0 billion** in FY 2007 to an **operating loss of $4.9 billion** in FY 2011, almost an $8 billion swing in Postal Service profitability over four years.

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[2] On November 28, 2008, the Business Cycle Dating Committee of the National Bureau of Economic Research ("NBER") identified December 2007 as being the peak prior month in economic activity in the U.S. economy — thereby constituting both the end of the last expansion and the beginning of what now is referred to as the "Great Recession." According to the NBER, the recession technically ended in June 2009. http://www.nber.org/cycles/dec2008.html. Recovery from the recession has been slow.

[3] Decline in mail volume, especially the volume of First-Class Mail, now is believed by most observers to be permanent. *See, e.g.*, 2011 Form 10-K Report, p. 41, Revenue Outlook. Under PAEA, First-Class Mail volume has declined 23 percent, from 95.9 million pieces in FY 2007 to 91.7 million pieces in FY 2008, to 83.8 million pieces in FY 2009, to 78.2 million pieces in FY 2010, to 73.8 million pieces in FY 2011.

Also, over the last five years, a **collection of loss-generating products** failed to cover their attributable costs by over **$6.6 billion**, as discussed in Sections III-V, *infra*.[4] These underwater products helped dig the Postal Service into a somewhat deeper financial hole. Thus, although the Postal Service has reduced work hours and costs by significant amounts, it is reasonable to conclude that its finances also have been severely worsened by Postal Service pricing. **Had the Postal Service avoided those losses on underwater products during the last five years, it would have had a cumulative profit from operations of around $2.3 billion, instead of a cumulative loss from operations of $4.3 billion.**

All Postal Service problems are dwarfed, of course, by the aggressive funding of retiree health benefits required by PAEA; this statutorily-created problem can be fixed only by Congress. The RHBF issue alone has driven the Postal Service to the very brink of insolvency, and is the subject of separate discussion in Section I.E, *infra.* Sections I.B, I.C, and I.D, *infra*, rest on the premise that Congress, one way or another, will fix the RHBF funding requirement in a manner that permits the Postal Service to continue operating to the end of FY 2012 and beyond.

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[4] Annual losses from **loss-generating products** (including special services) during this period were: FY 2007, **$0.50** billion; FY 2008, **$1.08** billion; FY 2009, **$1.67** billion; FY 2010, **$1.73** billion; and FY 2011, **$1.62** billion. *See* Section III, *infra*. These continuing losses from underwater products, including the Postal Service's inability to reduce, much less eliminate them, has been labeled a "systemic" problem by both the Postal Service and the Commission. *See* FY 2010 ACR, p. 7; FY 2009 Annual Compliance Determination ("ACD"), p. 20.

B. The Postal Service Expects Yet Another Significant Operating Loss in FY 2012.

In the current year, FY 2012, the Postal Service expects operating expenses to decrease by $0.9 billion. However, because of the anticipated decline in volume, there still is projected to be an **operating loss of $3.0 billion** (even before a further scheduled payment of $11.1 billion to the RHBF).[5]

> The fiscal year 2012 Integrated Financial Plan (IFP) has an Operating Plan with **a projected Operating Loss of $3.0 billion,** versus a [projected] loss of $2.2 billion in 2011, despite efforts to increase revenue and reduce costs. The 2012 net loss is forecast to be $14.1 billion, after $11.1 billion of pre-funding for retiree health benefits currently legislated for 2012. [FY 2012 Integrated Financial Plan ("IFP"), p. 1 (emphasis added).]

The FY 2011 IFP projected a $2.2 billion operating loss, but that projection turned into $4.9 billion loss, as shown in Table I-1, *supra*, 123 percent more than projected.

A $3.0 billion operating loss this year versus a $4.9 billion loss in FY 2011 does not reflect a turnaround that puts the Postal Service on the road to fiscal recovery. The $3.0 billion loss is premised on (i) a further decline in First-Class Mail volume of 6.3 billion pieces, or 8.6 percent from FY 2011 levels, and (ii) a decline in Standard Mail of 3.2 billion pieces, or 3.8 percent from FY 2011 levels. FY 2012 IFP, p. 2. The continuing volume loss in First-Class Mail does not foretell a turnaround or recovery.

For the first two months of FY 2012 (*i.e.*, through the end of November 2011), the volumes of First-Class and Standard Mail were down, respectively, 6.3 and 7.3 percent from

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[5] *See* FY 2011 Integrated Financial Plan, p. 2. The $0.9 billion operating loss includes payments for current retiree health benefits.

the same two months in FY 2011, generally confirming projections in the FY 2012 IFP. First-Class Mail was doing slightly better than projected, while Standard Mail was off more than projected. USPS Preliminary Financial Information (Unaudited), November 2011, p. 2 (filed Dec. 28, 2011).[6]

A $3.0 billion operating loss this year will seriously aggravate the Postal Service's already weakened financial condition. Should a larger operating loss materialize, as it did in FY 2011, the Postal Service might lack sufficient liquidity to pay all of its expenses, as discussed in Section I.C, *infra*.

C. Under PAEA, Postal Service's Net Worth Sank to a Negative $18.9 Billion in FY 2011, while Indebtedness Increased to $13.0 Billion, and Will Hit Its Statutory Limit of $15 Billion in FY 2012.

In order to pay PAEA-required contributions to the RHBF that could not be funded with net cash flow from operations, the Postal Service first exhausted its small reserves accumulated under the Postal Reorganization Act of 1970 ("PRA").[7] Since then, it has had to resort to extensive borrowing. As a result of PAEA, which has been financially disastrous for the Postal Service:

- **indebtedness** increased from **$2.1 billion** at the end of FY 2006, only months before PAEA was enacted, to **$13.0 billion** at the end of FY 2011, and is projected by the FY 2012 IFP to reach the statutory limit of $15.0 billion by the end of FY 2012.[8]

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[6] http://www.prc.gov/Docs/79/79064/NOV-11_PRC_-_Final_2.pdf.

[7] PRA, unlike PAEA, had a financial breakeven requirement which prevented the Postal Service from generating sustained excess cash flow or increased net worth.

[8] Postal Service borrowing authority has been restricted, under both PRA and PAEA, to no more than $3 billion per year, and to an aggregate amount of no more than $15

- **net worth** has gone from a **positive $6.3 billion** at the end of FY 2006 to a **negative $18.9 billion** at the end of FY 2011.[9]

In retrospect, it appears that PAEA has undermined Postal Service finances completely, despite the fact that it contains one objective which states that the modern system for regulating rates for market dominant products should be designed:

> To assure **adequate revenues**, including retained earnings, to maintain **financial stability**. [39 U.S.C. § 3622(b)(5) (emphasis added).]

As discussed in Section I.A, *supra*, a limited focus on results from operations indicates that the Postal Service complied with this objective, at least nominally, in the first two years under PAEA, and cumulatively for the first four years. In FY 2011, however, the Postal Service clearly came nowhere close to complying with this objective, even though compliance is critically important to the Postal Service's independent survival. That status might be called into doubt rather quickly if taxpayers are called upon to provide the Postal Service with annual operating subsidies.[10]

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billion. 39 U.S.C. § 2005(a). *See* 2011 Form 10-K Report, p. 76, Note 4, Debt Limits.

[9] FY 2011 Form 10-K Report, p. 65.

[10] The Commission's Annual Report to the President and Congress, FY 2011 (Dec. 2011), indicates that, under PAEA the Postal Service has reported a significant cumulative loss through FY 2011, principally caused by the $20.9 billion spent to pre-fund retiree health benefits. The Report implicitly acknowledges that the Postal Service is at risk of a cash shortfall, despite the fact that "the Commission's rules are intended to assure adequate revenue to maintain financial stability…." *Id.*, p. 15.

Although the Postal Service receives no operating subsidies from Congress, it received new vehicles from President Obama's economic stimulus package, as well as $190 million in appropriations relating to emergency preparedness over a three-year period.

> As part of the American Recovery and Reinvestment Act of 2009 (ARRA), we received approximately 6,500 new fuel-efficient vehicles between June 2009 and March 2010 from the General Services Administration in a one-for-one exchange for older postal vehicles....[11] Emergency preparedness appropriations were received from Congress to help pay the costs of keeping the mail, postal employees and postal customers safe, and are restricted for such use. These funds were accounted for as deferred revenue upon receipt and were generally utilized to procure capital equipment. Revenue for emergency preparedness appropriations is recognized when depreciation expense for the purchased equipment is recorded. The emergency preparedness appropriations revenue recognized during the years ended September 30, 2011, and 2010 was $63 million, and for the year ended September 30, 2009, was $64 million. [2011 Report on Form 10-K, United States Postal Service, pp. 11, 75.]

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[11] Although this infusion of new vehicles might seem to be helpful, on balance, Congress has forced the Postal Service to expend more money than required on vehicles. In 2011, the GAO issued a report on the Postal Service's delivery fleet which explained the unnecessary costs that were imposed on the Postal Service by Congress requiring its use of E85-capable vehicles by the Energy Policy Act of 1992. Not only were the vehicles more expensive to purchase, they were required to be the 6-cylinder type which were heavier and less efficient than 4-cylinder engines (even when using gasoline). Most of the Postal Service's E85 fleet had to obtain annual waivers from the Department of Energy to run exclusively on gasoline. Furthermore, any cost savings from using E85 versus gasoline were offset because E85 is about 27 to 30 percent less efficient than gasoline. *See* GAO Report, "United States Postal Service: Strategy Needed to Address Aging Delivery Fleet," GAO-11-386 (May 2011) http://www.gao.gov/new.items/d11386.pdf, pp. 15-21. The Postal Service cannot afford to be put on the cutting edge of Congressional efforts to develop experimental technologies in pursuit of non-postal policy objectives; use of expensive experimental vehicles will need to await a solvent Postal Service. *See* Valpak Comments to the Postal Regulatory Commission on the Operation of the Postal Accountability and Enhancement Act and Legislative Recommendations (July 18, 2011), pp. 47-48.

With the advantage of hindsight, the following three features of PAEA are seen now to be **fundamentally incompatible**:

1. the objective to assure revenues **adequate for financial stability and retained earnings**;

2. the PAEA-imposed burden to **pre-fund** future retiree health benefits in the amount of $56 billion within only 10 years; and

3. the CPI **price cap**, which generally takes precedence over all statutory objectives, including the one for financial stability cited here.[12]

With the price cap constraint it seems unlikely that any rate-making system designed by the Commission could have prevented the current financial crisis. Noncompliance with this key objective leading to insolvency was virtually guaranteed from the enactment of PAEA.[13]

Even without the price cap constraint on revenues, it seems doubtful whether any rate-making system would have been able to generate sufficient cash flow to fund the RHBF as mandated by PAEA. Market considerations, most especially the ongoing diversion of First-Class Mail arising from increased use of the Internet, forced downsizing.

This year's ACR raises one vital question. In view of:

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[12] "[T]he PAEA's price cap mechanism in section 3622(d)(1)(A) takes precedence over the statutory pricing objectives and factors in sections 3622(b) and (c), even if some of these can be considered quantitative." FY 2010 ACD, p. 18.

[13] The present liquidity crisis was clearly foreseeable, even if the precise timing was slightly less predictable. In 2006, the Board of Governors felt constrained as fiduciaries for the mailing public to take the politically-difficult step of strongly opposing enactment of PAEA. *See, e.g.,* U.S. Postal Service Board of Governors letter to Senator Susan M. Collins, Jan. 24, 2006 ("[W]e believe there are critical elements missing from this bill, as well as numerous burdensome provisions that would make it extremely difficult for the Postal Service to function in a modern, competitive environment.... [I]n keeping with our concerns that the Postal Service be able to provide the quality of service and reasonable rates ... we must oppose the passage of this bill.") http://www.apwu.org/postalreform/bogletter tosencollins012406.pdf.

(i) the continuing loss in volume of First-Class Mail,

(ii) the operating loss projected for FY 2012,

(iii) the lack of any financial cushion in the form of net worth or borrowing capacity, and

(iv) the limited ability to increase revenues as a result of the price cap

can the Postal Service's current structure and business model be repaired sufficiently within the confines of the existing law so as to achieve a return to sustainable profitability and overcome the financial damage inflicted by PAEA? Section VI, *infra*, discusses Postal Service efforts to restructure and reform its business model.

D. The Postal Service Needs to Restore Operational Profitability as Soon as Possible.

Since postal reorganization in 1971, financial independence has been a major over-arching goal of the Postal Service. As the *2011 Comprehensive Statement on Postal Operations* explains:

> The Postal Reorganization Act of 1970 created the Postal Service as an independent entity of the federal government, with the **responsibility to become self-sufficient.** [*Id.*, p. 34, (emphasis added).]

The self-financing model presumed that mail volume, particularly First-Class Mail volume, would continue to grow along with population and the economy. Another critically important underlying premise was that the monopoly would remain an effective barrier to erosion in the volume of First-Class Mail, thereby allowing the Postal Service to continue raising prices as necessary to support a number of politically-desired activities, regardless of

how costly or unprofitable those activities might be, or might become. Complacency with respect to these fundamental premises continued right through enactment of PAEA in 2006.[14]

The monopoly of course now has little, if any, residual value. The economic "rent," or surplus, previously enabled by the monopoly has been eroded completely, probably forever.[15] Clearly, whatever remains is totally inadequate to sustain the infrastructure (*e.g.*, uneconomic post offices, residential delivery 6 days a week, etc.) that Congress has imposed upon the Postal Service. The Postal Service must function as best it can in what now amounts to a hyper-competitive environment totally unlike any it has faced in the past.[16] Recommendations by the Commission with respect to cost reduction efforts by the Postal Service should **not assume that the monopoly has residual value** capable of subsidizing **any uneconomic activities**.

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[14] Significantly, despite PAEA's micro-management of certain aspects of the Postal Service, along with various other interferences, Congress at no time has indicated any willingness to appropriate taxpayer money, for example, to support the losses incurred by small uneconomic post offices, or to help pay for any of the other unfunded mandates that it has imposed on the Postal Service.

[15] The Commission recently concluded that, since 2007, the cost of the Universal Service Obligation has continued to increase while the value of the postal monopoly has declined sharply (by $1.93 billion), but that its current value nevertheless still remains significant. Commission Annual Report to the President and Congress, FY 2011, p. 43 (Tables 5 and 7). That finding is based on the dated and somewhat dubious **assumption** that, if the monopoly ceased to exist, widespread entry (and investment) by profit-seeking entrepreneurs then would occur even though mail volume is in a state of rapid decline.

[16] As a historical note, in the 1800's, when the predecessor Post Office Department was faced with competition from the Pony Express, Congress strengthened the monopoly so as to preclude the Pony Express from operating. The Postal Service subsequently survived electronic competition from the telephone and, later, from fax machines. With respect to the Internet, however, the genie is out of the bottle, and Congress cannot put it back.

Last year's ACD began with the following statement:

> In FY 2010, the Postal Service's financial situation continued to deteriorate. Cumulatively, it has lost over $20 billion since FY 2007 including $8.5 billion in FY 2010. These continuing losses, which are projected to persist in future fiscal years, jeopardize the Postal Service's ability to provide postal services to the nation as required by 39 U.S.C. 101. [FY 2010 ACD, p. 5.]

Indeed, the Postal Service's financial situation has deteriorated further, as last year's ACD anticipated. *See* Section I.A, *supra*. This year's ACR acknowledges the disruption to the Postal Service's business model.[17] However, the ACR limits itself largely to a presentation of required information, not addressing possible corrective actions which are vitally needed for survival.[18] The Postal Service anticipates that continued decline in the volume of First-Class Mail and the contribution which that mail makes, coupled with continued substantial losses on underwater products, will result in the Postal Service running out of money.[19]

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[17] The Postal Service is not alone. The Internet has disrupted permanently the business models (and profitability) of a number of firms in industries such as: (i) music (both recording companies and retailers); (ii) newspaper publishing; and (iii) book publishing (including book retailers). It may yet have similar disruptive effects on other media, such as the movie and TV industries.

[18] The recital of compliance in the ACR submitted by the Postal Service this year could be likened to dutifully, competently, and very neatly arranging the deck chairs on the RMS Titanic. It scarcely hints at the Postal Service's desperate financial condition. Compliance should include keeping the ship afloat, not just complying with all the nitty-gritty provisions of PAEA while the ship gradually goes down.

[19] Short-term, the Postal Service overpayment to the Federal Employees Retirement System ("FERS") could be refunded to alleviate the shortage of cash. As this overpayment was never taxpayer money, a refund of such money should not be considered a "bailout." Considering the rate at which the Postal Service is burning through cash, however, that cash will not last long. When it is gone, the Postal Service will need some kind of bailout, unless by then the Postal Service has returned to profitability.

> The IFP shows that there will be insufficient liquidity to make the pre-funding payments for retiree health benefits as we will have a liquidity shortfall of approximately $10.5 billion, under current legislation. **Excluding** the $11.1 billion of pre-funding payments, we will end FY2012 with a **cash balance of only $0.6 billion.** Liquidity at the end of October 2012, after our annual workers' compensation payment to the Department of Labor, is forecast to be as low as $0.1 billion. These are dangerously low levels of liquidity as we spend an average of $0.2 billion per day. [FY 2012 IFP, p. 1 (emphasis added).]

The day may come when the Postal Service will seek taxpayer support for current operations. Such an eventuality would mark the end of the Postal Service's financial independence.[20] Moreover, in the absence of profitability from operations, underfunding of future retiree health benefits never will be cured.

Returning operations to profitability primarily means reducing costs as revenue enhancement appears unlikely.[21] One thing that neither Congress nor the Commission nor the Postal Service can do is force mailers to send more mail. But the Commission can require the Postal Service to make **price adjustments** to underwater products designed to reduce losses from such products.

Price adjustments. Utilizing pricing flexibility to the maximum extent feasible, the Postal Service and the Commission as quickly as possible should seek to adjust prices in ways

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[20] In the event a taxpayer bailout should be necessary, it most assuredly would come with strings attached. Even generous bank bailouts have some strings attached.

[21] In view of the Postal Service's current financial condition, the last thing that it needs would be a surge in the volume of underwater products. That could be the proverbial "straw that breaks the camel's back." Fortunately, no such surge appears likely.

designed to make **every postal product** profitable in the sense that revenues from each product:

- cover attributable costs, and
- make a reasonable contribution to institutional costs (*see* 39 U.S.C. §§ 3622(c)(2) and 101(d)).

If the Commission prefers not to order increases in rates for underwater products, it should acknowledge this failure of PAEA, and recommend to Congress that it appropriate money to make up the shortfall. Changing the statute to have the rate cap apply to all classes of mail considered together — *i.e.*, price increases in one class could be above the cap provided that they are offset by below-cap increases in other classes — may be desirable, but it is not a cure for underwater products.

Continuing to tolerate losses on underwater products imposes a future financial burden that ultimately will have to be paid, one way or another, (i) by other mailers, which would be grossly unfair, (ii) by taxpayers (who will resist), or (iii) through cuts in service.

Price increases should be avoided on any reasonably-profitable product, especially if it has a moderately or highly elastic demand. Rather, upward price adjustments should be focused entirely on products that either are underwater or are only marginally profitable. The mandate for financial self-sufficiency means that the Postal Service should not adjust prices in a manner that would suggest it is operated like a charity. It is time for the Postal Service to put its finances in order.

Cost reductions. Last year's ACD states that "the price cap was understood as a feature that would focus management's attention on cost control." FY 2010 ACD, p. 19.

Operations, but not pricing, seems to have gotten the message. Seeing the continuing decline in the volume of First-Class Mail, management has, in addition to taking necessary steps aimed at reducing volume variable costs, also belatedly begun efforts to restructure and improve the Postal Service business model to achieve major reductions in institutional costs. *See* Section VI, *infra*, for a discussion of Postal Service's restructuring efforts to reduce costs.

E. PAEA-Mandated Funding for Retiree Health Care Benefits Urgently Needs a Longer-term Reform.

The requirement that the Postal Service pay for retiree health benefits is not a new obligation. All retirees from the federal government, including postal workers, are entitled to health care benefits. Since it was created in 1971, the Postal Service has been **funding** health insurance premiums for current retirees on a regular basis.

What is comparatively new is the Postal Service Retiree Health Benefits Fund ("RHBF"), created under PAEA for the purpose of **pre-funding** health benefits for **future** retirees. Fearing that in future years the Postal Service might be unable to pay retiree health care costs, Congress enacted Pub. L. 109-435, which established a 10-year schedule of payments averaging $5.6 billion per year that the Postal Service was required to pay into the RHBF.[22] These pre-funding payments are in addition to cash outlays for insurance premiums for current retirees. *See* Table I-1, rows 4 and 6.

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[22] In taking this action, Congress presumably foresaw potential problems in the Postal Service's future. Despite any such prescience, PAEA did virtually nothing to change the Postal Service's business model in ways that would enable it to fund the RHBF and cope with competitive changes being brought on by the Internet. *See* Section VI, *infra*, for discussion concerning restructuring of the Postal Service's business model.

The balance in the RHBF was $42.5 billion as of October 1, 2010. Interest earned on those funds subsequently increased the fund balance to $44.1 billion by September 30, 2011. *See* FY 2011 Form 10-K Report, p. 29. As discussed previously in Section I.C, *supra*, bringing the RHBF up to its current level used up all of the relatively meager reserves which the Postal Service had when PAEA was enacted, and forced the Postal Service to increase its outstanding debt to $13.0 billion at the end of FY 2011. *Id.*, p. 8.

The Commission's ACD last year showed clearly that the Postal Service now would have more than ample liquidity for its operations if not for the mandated RHBF payments. FY 2010 ACD, p. 26, Table IV-5. Thus, the Postal Service's current liquidity crisis is largely attributable to PAEA's wholly unrealistic requirement that the Postal Service, while continuing to fund all Congressional mandates in the law, **over the course of 10 years** deposit in the RHBF sufficient funds to pay **all estimated future retiree health benefits** accumulated over decades, past and future. The Commission has described this funding schedule in polite terms as "aggressive." In fact, the funding schedule in PAEA is far beyond aggressive — it is impossible. Under PAEA, the Postal Service's ability to increase its revenues and cash flow is **tightly constrained** by the price cap. The FY 2010 ACD notes that:

> The price cap is the signal feature distinguishing the modern [rate-making] system from the cost-of-service approach under the PRA. [FY 2010 ACD, p. 19.]

When PAEA was enacted, Congress somehow heroically assumed that the Postal Service could generate an additional $5+ billion per year in free cash flow, without increasing rates above the cap.

Realistically, the Postal Service currently has no means by which it could pay any part of the currently outstanding $11.1 billion obligation to the RHBF this year — much less next year, or the year after. As Valpak explained in its comments on last year's ACR,[23] PAEA's aggressive funding schedule can be viewed as constituting an extraordinary requirement insofar as no other federal, state, or local government, or agency thereof, is required to pre-fund its retiree health care benefits. To pretend that the Postal Service somehow can pay any portion of the currently outstanding $11.1 billion obligation over the next several years, much less any of the other future payments called for by PAEA, represents a waste of legislative time and effort as well as perpetuation of a false assumption.

Valpak's Initial Comments on the Postal Service's FY 2009 ACR and FY 2010 ACR discussed the desirability of avoiding a short-term Congressional "fix" for RHBF funding in favor of a more permanent remedy that would endure over a longer term and allow Congress and Postal Service management to focus on important restructuring issues.[24] Obviously, that message failed to resonate with Congress:

> The prefunding schedule was further changed on September 30, 2011, when H.R. 2017, the *Continuing Appropriations Act, 2012*, **deferred** the scheduled 2011 PSRHBF prefunding payment of $5.5 billion **to be due by October 4, 2011.** P.L. 112-36, the *Continuing Appropriations Act, 2012* [then] **extended** that deferment to **not later than November 18, 2011.** As a result, the total required 2012 prefunding payments are $11.1 billion: $5.5 due by November 18, 2011, plus $5.6 billion due by September 30, 2012. **To date, none of the law changes have**

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[23] Docket No. ACR2010, Valpak Initial Comments, pp. 4-22 (Feb. 2, 2011).

[24] Docket No. ACR2009, Valpak Initial Comments, pp. 22-28 (Feb. 1, 2010) and Docket No. ACR2010, pp. 17-22 (Feb. 2, 2011).

> **addressed the original prefunding payment requirements for 2012 to 2016.** [FY 2011 Form 10-K Report, p. 79 (emphasis added).]

Subsequent to the above events, and true to form, Congress again deferred the pre-funding payment due on November 18, 2011, this time until August 1, 2012. *See* Pub. L. 112-74.

Looking ahead, the FY 2012 IFP unhesitatingly states that by September 2012 the Postal Service:

> will have a liquidity shortfall of approximately $10.5 billion, under current legislation. **Excluding** the $11.1 billion of pre-funding payments, we will end FY2012 with a cash balance of only $0.6 billion. [FY 2012 IFP, p. 1 (emphasis added).]

This IFP forecast for FY 2012 demonstrates that one or more short-term Congressional fixes does not constitute a meaningful fix.

Each time Congress decides to take up the issue of RHBF funding, it can postpone the payments, but at some point its spending mandates will ensure that the Postal Service will not have any excess cash with which to increase the funding level for future retiree health obligations.[25]

Regardless of how often and by what means Congress elects to deal with the RHBF situation created by PAEA, Valpak would suggest that it is time for explicit recognition by Congress that funding of the RHBF is not going to work as envisioned in 2006 when PAEA was enacted. The reputation of the Postal Service as a reliable delivery service has great value which Congress and the Commission should strive to protect and enhance. A continued high

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[25] Possible cost reductions that would help restore profitability are discussed in Section VI, *infra*. Regardless of which initiatives are finally agreed upon, significant time will be required to implement and actually begin realizing full cost savings.

level of uncertainty, crisis atmosphere and high anxiety could induce some mailers to leave the Postal Service permanently in favor of competitive alternatives. It also is long past time for Congress to recognize the unreality of PAEA's original pre-funding schedule and devise a solution that hopefully will be workable for at least 5 or 10 years. That would provide Postal Service management with a more stable planning horizon than is allowed by a series of short-term postponements that only delay the inevitable.

Traditionally, retiree health benefits have been an "off-balance sheet" item for the Postal Service, as well as for the rest of the federal government (and private enterprise), and it continues to be an off-balance sheet item.[26] As a result, none of the scheduled future payments required under Pub. L. 109-435 appear as liabilities in the Postal Service's balance sheet. Similarly, the fund balance as of September 30, 2011 ($44.1 billion) does not appear as an asset on the balance sheet, and the estimated actuarial liability for future retiree health benefits ($90.3 billion) does not appear as a liability. At the same time, Postal Service debt that has been incurred to fund some of the annual required RHBF payments does appear on the balance sheet as a liability. And each year, as mandated payments became due and were paid, they were charged to expenses on the Postal Service's financial statements, which had the effect of reducing the Postal Service's reported profit or increasing its reported loss. At the end of FY 2011 the Postal Service's unfunded liability for future retiree health benefits was estimated (actuarially) at $46.2 billion. FY 2011 Form 10-K Report, p. 28. It also had a debt to the U.S. Treasury of $13 billion (soon to be $15 billion). *Id.*, p. 37. To the extent that the Postal

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[26] Pertinent information is publicly available, and is found in notes to the financial statements.

Service some day becomes unable to pay retiree health benefits and/or its debt to Treasury, ultimately the federal government is residually "on the hook" for both items.[27]

The net result is that when the Postal Service borrows money to make payments to the RHBF, the incurrence of such indebtedness shifts onto the Postal Service's balance sheet a portion of its pre-existing liability for retiree health benefits. The portion of the actuarial liability that is off-balance sheet and unfunded is reduced, while the on-balance sheet liability to Treasury is increased by an offsetting amount. Although such increased indebtedness on the balance sheet may beef up the amount of money in the RHBF, it does nothing to reduce the federal government's residual liability. True funding of retiree health benefits — and reduction of the government's residual liability — will not occur until the Postal Service is able to generate **operating profits** sufficient at least to reduce its **debt** and restore its **net worth** to the levels which existed when PAEA was enacted ($2.1 billion and $6.3 billion, respectively). That is why a return to **operating profitability** discussed in Section I.D, *supra*, is so important. And that cannot happen until Congress and the Commission together enable and facilitate Postal Service restructuring with respect to implementation of major cost reductions.

Due to the Postal Service's dire financial condition, Valpak would urge the Commission, in developing this year's compliance determination report, to address in its report the following topics.

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[27] Ever since the Postal Service was created on July 1, 1971, Congress has had little hesitation about directing how the Postal Service spent its money. Postal ratepayers have been saddled with a variety of expenses that arguably never should have been incurred, or else from the outset should have been paid by taxpayers or others. If Treasury (*i.e.*, taxpayers) were to wind up picking up the tab as a result of the Postal Service's inability to pay its bills, Congress should bear much of the blame.

1. Rather than limiting its report to compliance with "current law" (which cannot be reasonably assumed to remain unchanged), the Commission also should present one or more alternative scenarios that assume small or no annual payments for the RHBF.

2. When discussing the Postal Service's continuing inability to comply with conflicting statutory requirements, the Commission could help Congress by framing the issues and options in terms that would encourage an urgent and early resolution from Congress.[28]

II. POSTAL SERVICE PRICING STRATEGY IS DEEPLY FLAWED, PARTICULARLY FOR STANDARD MAIL.

A. The Postal Service Does Not Believe that It Needs a Strategic Pricing Plan.

1. U.S. Postal Service Inspector General Recommendations. On December 9, 2011, the Postal Service Office of Inspector General ("OIG") issued an audit report on Postal Service pricing.[29] This report reviewed the Postal Service approach to pricing practices, finding it both overly complex and fraught with a range of specific problems, such as unaddressed underwater products, Negotiated Service Agreements, etc. The report seemed to

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[28] PAEA envisions that the Commission will monitor and report to the President and Congress on the financial condition of the Postal Service, specifically including "the extent to which regulations are achieving the objectives under sections 3622 and 3633…." *See, e.g.*, 39 U.S.C. § 3651(a) ("Annual Reports by the Commission"). *See also* PAEA § 701 (uncodified, set out as notes under 39 U.S.C. § 501) (five-year "assessments of ratemaking, classification, and other provisions"). The PRC sent its first five-year report to Congress on September 22, 2011 ("Section 701 Report: Analysis of the Postal Accountability and Enhancement Act of 2006"). http://www.prc.gov/Docs/75/75994/701_Report-092211.pdf This report can be supplemented as necessary.

[29] United States Postal Service Office of Inspector General, Postal Service Pricing Strategy: Audit Report (Dec. 9, 2011), Report No. CI-AR-002. http://www.uspsoig.gov/foia_files/CI-AR-12-002.pdf (hereinafter "Pricing Strategy").

view postal pricing decisions as *ad hoc* in nature, rather than part of an overall strategic plan. In its conclusion, the report criticized the Postal Service, as follows:

> **The Postal Service does not have a strategic plan or mission statement for pricing**. In addition, Postal Service strategic documents such as *The Strategic Transformation Plan 2006 – 2010*, *Vision 2013*, and *Ensuring a Viable Postal Service for America: An Action Plan for the Future* do not include strategic plans for pricing. A mission statement defines an entity's **reason for existence**. A strategic plan or mission statement should be a clear and succinct statement of management's **purpose** for postage and associated costs.
>
> A pricing strategy would help the Postal Service **position itself in the marketplace**, differentiate the value of its products from those of the competition, and help it understand its data management needs to be competitive. Any entity that attempts to operate without a strategy or a mission statement runs the real risk of being **unable to verify that it is on course.** [Pricing Strategy, p. 6 (emphasis added).]

In issuing this report, the Inspector General was performing one of his most important functions, set out as Goal 1 in the OIG's Strategic Plan: "Help the Postal Service Focus on Customer Needs by Leveraging its Strengths and Improving its Operations."[30] Congress established the Postal Service Office of Inspector General in the Omnibus Consolidated Appropriations Act of 1997, Pub. L. 104-208, on September 30, 1996 — which, in turn, invoked provisions of the Inspector General Act of 1978, as amended, codified at 5 U.S.C. App. 3, §§ 1-13. The Inspector General reports to the Board of Governors, as does the Postmaster General. One would think that the expertise and recommendations of the Inspector

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[30] United States Postal Service Office of Inspector General, "Five Year Strategic Plan, FY 2011-FY 2015," p. 2. http://www.uspsoig.gov/Strat_Plan_FY2011-2015.pdf

General would be valued by Postal Service management, but that is not always true. In this particular instance the OIG recommendation fell on deaf ears:

> Management told us that "…the idea of a **pricing plan**, separate from a broader discussion of product strategy, is of **little use**." They view prices, price changes, and pricing structures as aspects of mail products and a pricing strategy as one element of a wider product goal. This wider view by Postal Service management is also **not part of a strategic plan or mission statement**. [Pricing Strategy, p. 6 (emphasis added).]

2. 39 U.S.C. section 3622(b)(6). Even if the Postal Service chooses to disregard recommendations of the Inspector General, one might think that it would be difficult for the Postal Service to disregard a mandate from Congress. However, its approach to pricing does that as well. One of the statutory objectives in PAEA was to "increase the transparency of the ratemaking process." 39 U.S.C. § 3622(b)(6). Without a written plan made available to the public, pricing decisions appear to be made by a person (or persons) behind the curtain,[31] without any reasoned explanation or rationale. Worse, decisions do not make sense on economic or legal grounds, running the risk that the decision-making process becomes politicized. One consequence of the absence of a pricing plan is that various voices within the Postal Service are able to push for and obtain preferential rates for their favorite products, based on vague notions about what is good for the Postal Service, without a systematic

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[31] In December 2011, James W. Kiefer, Ph.D., one of the Postal Service's men behind the curtain who explained that rationale for postal pricing on the record to the public during on-the-record hearings before the Postal Rate Commission at the end of the era of rates set by the Commission under the PRA, retired from the Postal Service. Under PAEA, there are no such hearings, and the Postal Service only grudgingly offers the most cursory of explanations for pricing decisions in its Annual Compliance Reports and Pricing Notices. In such a circumstance, the transparency that would be provided by a public, strategic plan takes on even greater importance.

requirement that those decisions be compared with either the requirements of PAEA or the effect such decisions are having on Postal Service's financial situation.

3. Postal Service *Ad Hoc* Pricing Decisions. The Postal Service imposes high price increases on products with high elasticity, while imposing low price increases on products with low elasticity, and has markedly different coverages on various products within Standard Mail — all for no apparent reason. *See* Section II.B, *infra*. Its pricing provides certain mailers of underwater products with huge subsidies — not from its own money, but money extracted from other mailers, who are sometimes competitors of the benefitted mailers. It has wasted time and money on Negotiated Service Agreements. *See* Section II.C, *infra*. It has lost billions on underwater products. *See* Section III, *infra*. *See also*, Section IV, *infra*, regarding Standard Mail Flats, and Section V, *infra*, regarding Periodicals. The risk underscored by the OIG's Pricing Strategy — that the Postal Service's *ad hoc* approach "runs the real risk of being unable to verify that it is on course" — is now upon us.

B. Without a Strategic Pricing Plan, Pricing Changes and Cost Coverages Continue to Be Completely Out of Whack, Especially for Standard Mail.

1. Pricing to Maximize Operating Income. Virtually the only Postal Service statement relating to a pricing strategy is buried in "The 2010 Annual Performance Report and 2011 Annual Performance Plan" appended to "Foundation for the Future: 2010 Comprehensive Statement on Postal Operations." This Performance Plan for 2011 establishes the Strategic Goal to "Improve Financial Performance." It sets out as its first "New Financial Performance Indicators for 2011 — **Operating Income**," as follows:

> This measure is the net of total operating revenue minus total operating expenses. It replaces Total Revenue as a corporate

> objective. Operating revenue includes all postage, fees, and other funds obtained from the sale of products and services. Operating expenses include all expenses other than prefunding retiree health benefits and adjustments to Workers Compensation liabilities that result from changes in discount rates or actuarial assumptions. It is a measure of **profitability** within management's control. [2010 Annual Performance Report and 2011 Annual Performance Plan, p. 6. (emphasis added)].[32]

This shift from maximizing revenues to maximizing profitability signaled a refreshing change of direction toward a more business-like approach. Particularly, in view of the Postal Service's financial condition, a profitability maximization goal seems entirely appropriate. Thus, one might speculate that maximization of operating income would have been a key guiding principle underlying the Postal Service's pricing decisions and pricing strategy in the last pricing notice, reviewed in Docket No. R2012-3. However, no principle of profitability can be found in the Postal Service's enthusiastic support for underpricing on Standard Flats, which loses large sums of money — over $2 billion and counting during the past four years. *See* Postal Service Responses to ChIR No. 1, Q. 9(c) (Jan. 27, 2012). In order to preserve its ability to underprice Standard Flats, the Postal Service even filed a Petition for Review in federal court challenging the Commission's last Annual Compliance Determination.

For the Standard Mail class, the CPI rate cap determines the total additional revenue to which the Postal Service can aspire in any given year. Since total revenue is constrained, the way to increase operating profit within that revenue constraint is to (i) focus on retaining volume with the highest contribution and coverage, and (ii) focus rate increases on those products with the lowest contribution and coverage (starting, of course, with underwater

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[32] http://www.prc.gov/Docs/71/71364/FY10.17.Comp.Stat.Postal.Ops.pdf

products), knowing that higher rates will lead to some volume loss. The Postal Service has not done this. Moreover, as discussed in the next section, pricing decisions for the four profitable Standard Mail products also are routinely at odds with any notion of maximization of operating income. One searches in vain for a principle which underlies the Postal Service's pricing decisions in Standard Mail.

Rather than embracing a pricing principle, the Postal Service zealously defends its prerogative to make any pricing decision it chooses, based on its reading of PAEA, irrespective of the views of the Commission. This strategy, which obviously does not enhance transparency, usually manifests itself as a defense of the authority of the Governors to do as they please in setting prices, a point repeated yet again only days ago:

> In discussing … future pricing, it must be remembered that all pricing decisions are made by the Governors, following a careful consideration of the statutory and regulatory requirements as well as an evaluation of market dynamics and business strategy considerations. These decisions can be made only within the context of the circumstances that exist at the time a specific price change is approved. [Docket No. ACR2011, Postal Service Responses to ChIR No. 1, Q. 9(c) (Jan. 27, 2012).]

2. Demand-based Pricing. Another hint of Postal Service pricing strategy occurred in March 2010, when the Postal Service identified as one of its legislative objectives, to "[e]nsure that prices of market dominant products can be **based on the demand** for each individual product and its costs, rather than capping prices for every class at the rate of inflation."[33] (Emphasis added.) Specifically, the Postal Service wanted Congress to apply the price cap to

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[33] U.S. Postal Service, "Ensuring a Viable Postal Service for America: An Action Plan for the Future," p. 1. http://about.usps.com/transforming-business/future-postal-service.htm

all market dominant products, and indicated that it wanted prices of underwater classes set to cover their costs. Even though the Postal Service has steadfastly failed to use the power that it now has to follow a demand-based pricing strategy among the profitable products in Standard Mail, it seeks additional authority from Congress to base prices on product demand. As to what end such additional authority might be used, one only can speculate.

If the Postal Service were to practice the principle to which it gives lip service, one would have expected to see price increases within a class imposed primarily on products where mailers have fewer alternatives, and therefore would be willing to pay a higher price without significantly reducing demand — products over which the Postal Service could be said to have more market power. On the other hand, one might expect the Postal Service to mitigate price increases for profitable products that mailers would use much less of (or abandon altogether) if prices were to increase too sharply. Such a strategy would maintain revenues at the limit of the cap while having the least impact on volume and operating profit. It is difficult to find any evidence that the Postal Service is setting prices in this manner within Standard Mail. Also, one would expect to see products where mailers have few alternatives bear a relatively larger share of institutional costs than mailers with many alternatives. It is likewise difficult to find support for this proposition within Standard Mail.

3. Elasticity of Demand. Historically, Postal Service pricing took into account the elasticity of demand for various products. The importance of elasticity of demand is discussed by Commission Rules, which require that:

> [b]y January 20 of each year, the Postal Service shall provide econometric estimates of **demand elasticity for all postal products** accompanied by the underlying econometric models and

> the input data sets used; and a **volume forecast** for the current fiscal year, and the underlying volume forecasting model. [39 C.F.R. § 3050.26 (emphasis added).]

Own-price elasticity measures the degree to which demand for a product is responsive to changes in price for that product. It is measured as the percentage change in quantity demanded in response to a 1 percent change in price.[34] In the world of postal products, discussion generally relates to price increases, not decreases. Products for which demand is highly responsive to increases in prices are said to have highly "elastic" demand. Products for which demand remains fairly constant in the face of moderate price increases are said to have relatively "inelastic" demand.

The most recent January 2012 estimates[35] of price elasticity for all market dominant products are set out in Table II-1, along with estimates previously submitted in January 2011, which were the elasticity estimates available to the Postal Service at the time its last price adjustments were noticed.[36] The former Standard ECR subclass, which includes three Standard Mail products (High Density/Saturation Letters, High Density/Saturation Flats, and Carrier Route), had an estimated elasticity of **0.727** in January 2011, and in January of this year it was

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[34] Since price increases almost always lead to reduced demand, price elasticities technically are negative numbers, but the minus sign generally is not used when elasticity is stated.

[35] http://www.prc.gov/Docs/79/79839/MDM_20120120165520.pdf

[36] *See* Demand Analysis submitted to the Commission January 20, 2012 and January 20, 2011 in accordance with Commission Rule 3050.26, Folder: Market Dominant; File: Demand Equation Tables, pp. 1-14. In certain instances, elasticities are estimated only for former subclasses, or groups of products — *e.g.*, Standard Regular Mail or Standard ECR — not for individual products within Standard Mail.

0.782 (row 7). Of all computed elasticities, the former ECR subclass continues to be near the top of the list, behind only the much smaller parcel product Media/Library Mail, and more or less equal to that of Bound Printed Matter.[37]

Table II-1
Elasticity of Market Dominant Products
(Absolute value)

	January 2011	January 2012
1. First-Class Single-piece letters	0.182	0.189
2. First-Class Presort letters	0.346	0.436
3. First-Class Single-piece cards	0.249	0.063
4. First-Class Presort cards	1.397	0.292
5. Periodicals	0.133	0.122
6. Standard Regular Mail	0.286	0.335
7. Standard ECR Mail	**0.727**	**0.782**
8. Standard Nonprofit Mail	0.177	0.265
9. Standard Nonprofit ECR	0.513	0.542
10. Parcel Post	0.389	0.366
11. Bound Printed Matter	0.719	0.774
12. Media/Library Mail	0.847	0.832

Sources: Demand Analysis submitted to the Commission January 20, 2011 and January 20, 2012.

4. Standard Mail Pricing. If the Postal Service was basing product prices on demand, it would be expected to impose higher price increases on products with lower elasticity, and lower price increases on products with higher elasticity. In Docket No. R2012-3, the Postal Service implemented price increases for Standard Mail on January 22,

[37] In FY 2011, Standard Mail volume was 84.7 billion, compared with Bound Printed Mail at 497 million, and Media/Library Mail at 108 million. FY 2010 ACR, pp. 20, 36

2012, as shown in Table II-2, below. The Postal Service's price changes were within a relatively narrow band around the class-wide average of 2.041 percent, with continued large increases on the two former ECR products with high elasticity and the highest coverage — Carrier Route and High Density/Saturation Letters.

Table II-2
Standard Mail Product Price Changes of Jan. 22, 2012
by Former Subclass

Product	Price Change (%)	Commercial Elasticity
Former Regular Subclass:		
Standard Letters	1.867	0.335
Standard Flats	2.209	0.335
Standard Parcels/NFMs	2.864	0.335
Former ECR Subclass:		
HD/Sat Letters	2.298	0.872
HD/Sat Flats and Parcels	2.121	0.872
Carrier Route	2.425	0.872
Average Standard Mail	2.041	

Source: Docket No. R2012-3.

Comparing the two flats products in Standard Mail, the Postal Service's most recent price adjustments imposes a larger percentage increase on the profitable product with the higher elasticity, Carrier Route, than on Standard Flats, the deeply underwater product with a lower elasticity. Such pricing decisions do not fall within any meaningful description of "profit-maximizing" or "demand-based," and no rationale in support of such apparently irrational decisions is offered. Although management is said to "view prices, price changes, and pricing structures as aspects of mail products and a pricing strategy as one element of a

wider product goal" (Pricing Strategy, p. 6), in no instance regarding those pricing decisions is that wider product goal given meaningful enunciation.

5. Standard Mail Cost Coverage. Looking beyond price increases imposed in any one year, it is instructive to compare the share of institutional costs that products with high elasticity are asked to pay versus the share that products with low elasticity are asked to pay. One would think that demand-based pricing would tend to impose a greater share of institutional costs on products with low elasticity of demand, but with respect to Standard Mail, the reverse appears to be true. An analysis based on cost coverage within Standard Mail certainly does not demonstrate that pricing over the years has been demand-based.

Table II-3 below shows coverages of Standard Mail products alongside their subclass elasticity. Of the six commercial products within Standard Mail, revenues from two products with the lowest elasticity did not even cover their attributable cost, as Flats and NFMs/Parcels were substantially underwater. In FY 2011, the underwater portion of the attributable cost of these two products had to be subsidized from operating profits earned on other Standard Mail products — particularly High Density/Saturation Letters and High Density/Saturation Parcels.

Table II-3
Standard Mail Product Cost Coverages and Elasticities
by Former Subclass

Product	Cost Coverage	Commercial Elasticity
Former Regular Subclass:		
Regular Letters	183.6%	0.335
Regular Flats	79.3%	0.335
Regular NFMs/Parcels	84.8%	0.335
Former ECR Subclass:		
HD/Sat Letters	220.0%	0.782
HD/Sat Flats/Parcels	213.0%	0.782
Carrier Route	134.8%	0.782
Standard Class Weighted Average	147.6%	

Source: Coverages from USPS-FY11-1; Elasticities from Table II-1, above.

All Standard Mail is similar in terms of content: largely advertising mail. The coverage for the class is 147.6 percent.[38] Yet the two high-elasticity saturation products had coverages completely disproportionate to the other products, well over 200 percent: High Density/Saturation Letters and High Density/Saturation Flats and Parcels. This excessive coverage cannot be explained by the content or the elasticity of the mail. Nor has the Postal Service ever adequately explained why this coverage is allowed to be so disproportionately high.

[38] To get an idea of the upper and lower bound of increasing prices for Standard Flats, consider two scenarios. If all revenues and costs of Standard Flats were eliminated from Standard Mail, coverage for the class would be 171.6 percent, a substantial improvement over 147.6 percent. If, hypothetically, revenues for Standard Flats were to be increased to 100 percent coverage while volume and costs remained unchanged, coverage for the class would be 153.3 percent.

6. Prior Commission Consideration of Standard Mail Coverages. Valpak continues to object strenuously to excessively high coverage for High Density/Saturation Letters. For the same reason, the coverage for High Density/Saturation Flats/Parcels is also too high. This is certainly not the first year that Valpak has raised these objections. *See* Docket No. ACR2007, Valpak Comments,[39] pp. 39-40; Docket No. ACR2008, Valpak Comments,[40] pp. 43-58; Docket No. ACR2009, Valpak Comments,[41] pp. 44-49, and Docket No. ACR2010, Valpak Comments,[42] pp. 54-71.

Although the Commission did not directly address the issue in Docket No. ACR2007[43] and Docket No. ACR2008,[44] the Commission commented on Valpak's argument in Docket No. ACR2009:

> In its comments, Valpak argues for a "significant reduction in the coverage of High-Density/Saturation products." Valpak Comments at 49. Valpak states that categories with relatively elastic demand should have relatively low cost coverages and thus pricing of High Density and Saturation products is not optimal.

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39 http://www.prc.gov/Docs/58/58756/Valpak_ACR2007_Initial_Comments.pdf

40 http://www.prc.gov/Docs/62/62024/VP%20ACR2008%20Initial%20Comments.pdf

41 http://www.prc.gov/Docs/66/66609/VP%20ACR2009%20Initial%20Comments.pdf

42 http://www.prc.gov/Docs/71/71786/Valpak%20ACR2010%20Initial%20Comments.pdf

43 http://www.prc.gov/Docs/59/59460/ACR2007Report.pdf

44 http://www.prc.gov/Docs/62/62784/ACD%20Report_2008_FINAL.pdf

> In Docket No. R2009-2, the Postal Service gave **below average increases** to High Density and Saturation Letters (1.248 percent) and High Density and Saturation Flats/Parcels (2.233 percent). The Postal Service explained that the below average increases were **in recognition of the market characteristics** of these products. Thus, it appears the Postal Service has attempted to be responsive to the concerns expressed by Valpak. [FY 2009 ACD, p. 87 (emphasis added).[45]]

In Docket No. ACR2010, the Commission discussed High Density and Saturation Letters similarly:

> In FY 2010, the High Density and Saturation Letters product had a cost coverage of 212.8 percent. It contributed $393.0 million to the institutional cost of the Postal Service. Both the nonprofit and commercial components of the High Density and Saturation Letters product made a positive contribution to institutional cost. In its comments, **Valpak argues that "pricing and cost coverage** on high density/saturation mail **remain too high**." Valpak Comments at 65. Valpak states that categories with relatively **elastic demand** should have relatively low cost coverages and thus pricing of High Density and Saturation products **is not optimal.** Valpak Comments at 65.
>
> In Docket No. R2011-2, the Postal Service proposed **below average increases** to High Density and Saturation Letters (0.615 percent) and High Density and Saturation Flats/Parcels (0.403 percent). The Postal Service explained that the below average increases were in recognition of the market characteristics of these products. [FY 2010 ACD, p. 108 (emphasis added).]

7. Valpak Request for Commission Guidance to Postal Service on Saturation Product Coverages. Any effort to give the highest coverage saturation products below-average increases ended with the January 2012 price increase, when the Postal Service gave both High Density/Saturation products above-average increases. Although the Commission

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[45] http://www.prc.gov/Docs/67/67396/ACD-2009%20%281%29.pdf

has appeared to understand that the cost coverage of the saturation products was too high in two consecutive annual reviews, the Postal Service appears not to share that conviction. Nor has the Postal Service provided any rationale that would explain or support its seemingly *ad hoc* pricing decisions.

Valpak requests the Commission to find that the coverages for High Density/Saturation Letters and High Density/Saturation Flats/Parcels are too high, and should be lowered significantly, and soon. **Valpak urges the Commission to enter a remedial order to roll back the most recent price increases that were imposed on these products on January 22, 2012: 2.298 percent on High Density/Saturation Letters, and 2.878 percent on High Density/Saturation Flats/Parcels**.[46] Beyond that, Valpak believes that no product should pay prices greater than twice their attributable costs, particularly when other mailers are paying far less than their attributable costs, and Valpak suggests that future price increases on these high coverage High Density/Saturation products with highly elastic demand be suspended until coverage for each product is no more than 199 percent. *See* subsection B.6, *supra*.

Further, Valpak would suggest that the Commission request the Postal Service to give its pricing decision **more transparency** by providing a more detailed statement of the "wider product goal" that underlies its pricing decisions in the year covered by each ACR, along with an explanation as to how its pricing decisions conform to those goals and objectives.[47]

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[46] *See* U.S. Postal Service Notice of Market-Dominant Price Adjustment (Oct. 18, 2011), p. 18. http://www.prc.gov/Docs/76/76795/Notice%20of%20Rate%20Adjustment%20Final.pdf.

[47] *See* Pricing Strategy, p. 6.

Finally, the Postal Service has offered a variety of Standard Mail incentive programs targeted at, or available to, saturation mailers. While these efforts are appreciated, Valpak continues to believe that lower rates for all saturation mail is the preferable approach to preserve existing volume and encourage growth of new volume.[48]

C. Market Dominant NSA's.

The Postal Service reported that during FY 2011 it had three (domestic) market dominant Negotiated Service Agreements ("NSAs") in effect: The Bradford Group, Life Line Screening, and Discover Financial Services, LLC. But only The Bradford Group qualified for a discount — in the form of a $114,000 rebate. Under the Panzar/Wolak valuation method, the cumulative net effect was $55,038, and under the Postal Service valuation method the cumulative benefit was a negative $114,000. *See* FY 2011 ACR, pp. 47-48; USPS-FY11-30.

Market dominant NSAs have proved to be a terrible waste of time and money for the Postal Service. Any NSA that can be offered to one mailer should be offered to other similarly situated mailers. It is much better for the Postal Service to offer a niche classification to all qualified mailers at the outset, rather than requiring mailers to force their way into the deal

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[48] The Commission's ability to evaluate such incentive programs is limited, and its efforts to obtain better tools thus far have been unsuccessful. In May 2011, the Commission terminated proceedings in a docket designed to develop new methods to estimate volume changes resulting from pricing incentive programs of the Postal Service. The Commission was "not persuaded that the alternatives [proposed] offer a demonstrable improvement over the current method" which uses price elasticity. The Postal Service was asked "to attempt to identify a more reliable method for evaluating the impact of price incentives and to continue collecting data that could be used for that purpose." Order No. 738, Docket No. RM2010-9 (May 27, 2011), pp. 1-2. http://www.prc.gov/Docs/73/73085/Order_No_738.pdf. Valpak's reply comments in that docket focused on the problems inherent in the use of short-run marginal costs in evaluating the profitability of pricing incentive programs. http://www.prc.gov/Docs/71/71921/Valpak%20RM2010-9%20Reply%20Comments.pdf.

long after their competitor is benefitted. This problem is illustrated by the problem created when the Bank of America Corporation was given an NSA, and Capital One Services, Inc. found it impossible to get the same deal. That resulted in discrimination among mailers, harm to the marketplace, expensive litigation before the Commission, a settlement (the terms of which were never revealed to the public), substantial losses to the Postal Service that outweighed cumulative profits on all other market dominant NSAs and, finally, cancellation of the Bank of America Corporation NSA. *See generally* Docket No. C2008-3. *See also* Docket No. ACR2009, Valpak Initial Comments, pp. 65-73; FY 2009 ACD, pp. 112-114.

More recently, in his December 9, 2011 report, Pricing Strategy, the Inspector General commented with respect to the Bank of America Corporation NSA that "the baseline data used to determine the improvements was 1999 system-wide data, not specific to the corporation.... Since read/accept rates for mail processing equipment have improved in the intervening years, the 1999 rates did not provide a valid baseline for the agreement." Pricing Strategy, p. 5.

The only conclusion that can be drawn from the Postal Service's experience with market dominant NSAs is that they have been a failure, should not be repeated, and should be replaced by filings for niche classifications[49] when and where appropriate.

[49] *See, e.g.*, Docket No. MC99-1 and Docket No. MC99-2 regarding weight-averaged non-letter size business reply mail.

III. THE POSTAL SERVICE CONTINUES TO SUSTAIN ENORMOUS LOSSES FROM UNDERWATER PRODUCTS.

A. In FY 2011 the Postal Service Lost Over $1.6 Billion on Eight Products, Causing this Group of Products to Not Be in Compliance with PAEA.

Although the Commission's analysis of compliance with PAEA in prior annual compliance reviews has been reviewed product by product, that is not the only way that the Commission can view it. Section 3653(b) requires the Commission to:

> make a written determination as to — (1) whether any rates or fees in effect during such year (for products **individually or collectively**) were not in compliance with applicable provisions of this chapter (or regulations promulgated thereunder)…. [39 U.S.C. § 3653(b) (emphasis added).]

Thus, it not only is interesting, but also essential, to consider all underwater products as a whole.

The Postal Service lost a bit less on market dominant mailing products in FY 2011 than FY 2010: improving slightly (by 4.4 percent), from a loss of $1.689 billion in FY 2010 to a still abominable loss of $1.615 billion in FY 2011. This year, two entire classes are underwater: Periodicals and Package Services. Of the eight products losing money, the largest losses are from Standard Mail Flats and Periodicals Outside County. Losses from these two products ($1.249 billion) make up 77 percent of the $1.615 billion loss from all eight underwater products. In turn, the loss from these eight products constituted almost one-third (32.8 percent) of the Postal Service's FY 2011 operating loss of $4.923 billion, shown in Table I-1, *supra*. The Postal Service's current financial circumstances as discussed in Section I, *supra*, do not permit it the luxury of nursing along underwater products. Losses from these products have, in part, forced the Postal Service to announce initiatives that would make major

service reductions (*e.g.*, 5-day delivery and elimination of overnight service for First-Class Mail and Periodicals, closing of small post offices), but it has taken little action to stop — or at least substantially reduce — losses from underwater products.

Table III-1
Loss-Generating Market Dominant Products, FY 2010-2011
(Exclusive of Special Services)

Product	FY 2010 Deficit ($, millions)	FY 2010 Cost Coverage	FY 2011 Deficit ($, million)	FY 2011 Coverage
First-Class Parcels	$1	99.9%	—	—
Inbound Int. Single-Piece First-Class Mail	$53	79.3%	$36	79.0%
Standard Mail Flats	$582	81.6%	$652	79.3%
Standard Mail NFMs and Parcels	$178	77.2%	$117	84.8%
Periodicals Within County	$25	74.2%	$20	77.5%
Periodicals Outside County	$598	75.0%	$597	74.5%
Single-piece Parcel Post	$134	82.1%	$89	89.2%
Bound Printed Matter Parcels	$28	92.1%	$5	98.4%
Media and Library Mail	$90	80.4%	$99	77.0%
Total	**$1,689**		**$1,615**	

Sources: Tables 1-4, FY 2010 ACR; Tables 1-4, FY 2011 ACR.

In FY 2011, the First-Class Parcels product went from underwater to above water. But the other eight market dominant products that were underwater in FY 2010 remain there.

Viewed "collectively," at a minimum, all eight products violate 39 U.S.C. section 3622(b)(5) (the objective of ensuring adequate revenues); section 3622(c)(2) (the factor that each type of mail service bear its attributable costs and make a contribution to institutional costs); and section 101(d) (the mandate that the costs of all postal operations be apportioned to all users of the mail on a fair and equitable basis).

Furthermore, as noted in Section I, above, underwater products have lost the Postal Service $6.6 billion since PAEA was enacted. But for those losses, the Postal Service would have had a cumulative operating profit of $2.3 billion, instead of a cumulative operating loss of $4.3 billion, over this period.

B. The Periodicals Mail Study and the Flats Strategy Confirm that Pricing Actions Will Be Required for Periodicals and Standard Mail Flats.

1. Periodicals Mail Study. PAEA, enacted on December 20, 2006, mandated that the Postal Service and the Commission jointly study and submit to the President and Congress a report on:

> (1) the quality, accuracy, and completeness of the information used by the Postal Service in determining the direct and indirect postal costs attributable to periodicals; and
> (2) any opportunities that might exist for improving efficiencies in the collection, handling, transportation, or delivery of periodicals by the Postal Service, including any pricing incentives for mailers that might be appropriate. [Pub. L. 109-435, Section 708.]

Congress established no deadline for the study, and it dragged on. The Commission deferred a finding of noncompliance and ordering of remedial action with respect to Periodicals, due to the pendency of this study in the last three Annual Compliance Determinations. *See* Section V, *infra*. Nevertheless, at long last, the joint report was issued in

September 2011, just short of five years after enactment of PAEA.[50] Although the report dealt primarily with Periodicals, it also discusses the Postal Service's limited ability to reduce the costs of processing **Standard Mail Flats**.

The Periodicals Mail Study confirmed that all cost savings that the Postal Service and the Commission possibly could fathom would not be sufficient to bring the Periodicals class above water. "**Cost savings** opportunities exist, but are **not likely** to be sufficient to bring Periodicals to **breakeven**." Periodicals Mail Study, p. 91 (emphasis added). With the entire class underwater by more than 20 percent, CPI-limited price adjustments also would be insufficient to return Periodicals to a breakeven status. Apart from a change in the law,[51] the only pricing options available while maintaining Periodicals as a mail class would be through an exigent price adjustment (which the Commission rejected in Docket No. R2010-4), or remedial action by the Commission as part of the annual compliance review process. *See id.*, p. 92. The Periodicals Mail Study also noted that the Commission "declined to discuss its remedial powers for raising the Periodicals cost coverage" in its FY 2010 ACD. *Id.*

With issuance of the Periodicals Mail Study, there are no more reasons for the Commission not to use its remedial powers to help the Postal Service's financial condition by increasing prices for both Periodicals products. The Periodicals Mail Study stated:

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[50] http://www.prc.gov/Docs/76/76767/Periodicals%20Mail%20Study_final_2131_2149.pdf.

[51] In another context, the Commission stated that it cannot wait for Congress to act, because "the legislative process is uncertain, and the results of pending legislation are highly speculative." Docket No. R2010-4R, Order No. 937, Order Denying Motion to Stay and Establishing Further Procedures, pp. 7-8.

> The aforementioned legislative change and/or regulatory action, in concert with the operational efficiency opportunities detailed above, would enable substantial progress in closing the financial gap for Periodicals. Absent these changes, however, Congress is left with the **stark choice** of providing a subsidy or allowing Periodicals to not cover its costs (which would have the effect of cross subsidy from other classes of mail, and/or greater borrowing by the Postal Service).
>
> Clearly, some **tough choices** will be required to achieve the important balance between the Postal Service's long-term financial viability and the societal value of Periodicals for the educational, cultural, scientific, and informational content they provide. [*Id.*, p. 92 (emphasis added).]

2. Flats Strategy. Likewise, the Postal Service's "**Flats Strategy**" filed with its exigent rate request in Docket No. R2010-4 confirmed that cost-cutting strategies alone would not return Periodicals to compliance with section 3622(c)(2): "even if the Postal Service achieves the most optimistic efficiency enhancements possible, it does not foresee that such enhancements, combined with annual rate increases within the statutory price cap, will result in **Periodicals**, **Standard Mail Flats**, and Standard Mail NFMs/Parcels reaching full attributable cost coverage." FY 2010 ACR, p. 8 (emphasis added). *See* further discussion of the Flats Strategy in Section IV, *infra*.

3. Conclusion. There is no doubt that stark and tough choices must be made. Without legislative action, such choices are now the domain of the Postal Service and the Commission. Because the Postal Service has not been **willing** to raise **Standard Mail Flats** prices sufficiently, and has not been **able** to raise **Periodicals** prices sufficiently, the burden falls on the Commission to act. Sections IV and V, *infra*, discuss Standard Mail Flats and Periodicals, respectively.

IV. THE PROBLEM OF DEEPLY UNDERWATER STANDARD MAIL FLATS PERSISTS, DESPITE THE COMMISSION'S FINDING OF NONCOMPLIANCE WITH PAEA.

A. In Its FY 2010 ACD, the Commission Found the Standard Mail Flats Product Prices Not in Compliance with PAEA.

Standard Mail Flats is one of six products in the Standard Mail class.[52] In the last ACD, the Commission's discussion of the threat posed to the Postal Service by the Standard Flats product was extensive. Greater attention was given to the problem of Standard Flats than any other issue. At the conclusion of its analysis, and for the first time, the Commission's FY 2010 ACD exercised its authority to find a product not in compliance with PAEA, ordering the Postal Service to take remedial action. The Commission's actions were required by the adamant refusal of the Postal Service to follow prior Commission pricing guidance, and by the financial deterioration of the product. As discussed *infra*, since the last ACD, the Postal Service has continued to refuse to improve the pricing of Standard Mail Flats, and the damage being done by this product to the Postal Service has increased significantly.

> Pursuant to 39 U.S.C. 3652(a)(1), the Postal Service is required, among other things, to "demonstrate that all products during such year **complied with all applicable requirements of [title 39]**." In this ACR, the Postal Service does not attempt to make that showing, simply noting that "the Flats product had a cost coverage of **81.6 percent** in FY 2010." FY 2010 ACR at 31.
>
> The Postal Service expressly recognizes that pricing and efficiency measures need to be taken to ensure that the Flats product **covers its costs and makes an appropriate contribution** toward institutional costs. Id. It suggests, however, its plans were nullified by the Commission's denial of its exigent rate request. In its most recent price adjustment proceeding, Docket No. R2011-2, the Postal Service reverted to the

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[52] The six Standard Mail class products are Letters, Flats, Parcels/NFMs, Carrier Route Letters, Flats, and Parcels, High Density and Saturation Letters, and High Density and Saturation Flats and Parcels. All of those products generate significant contribution, except for Standard Flats and Parcels/NFMs.

previous pattern of **below-average price increases** for Flats it followed in the prior two price adjustment proceedings under the PAEA.

In its review of the Postal Service's ACR, the Commission must determine "whether any rates or fees in effect for such year (for products individually or collectively) were not in compliance with applicable provisions of [chapter 36 of title 39] (or regulations promulgated thereunder)." Among the provisions of chapter 36 is **39 U.S.C. 3622(c)(14)**, which as part of the modern system for regulating rates and classes for market dominant products, requires the Commission to take into account "the policies of this title as well as other factors as the Commission determines appropriate." While many of the section 3622(c) factors were simply imported from former 39 U.S.C. 3622(b), section 3622(c)(14) represents a synthesis of former section 3622(b) language that the Commission's recommended rates be "in accordance with the policies of this title" and section 3622(b)(9) that in addition to the eight enumerated factors, the Commission could also consider "such other factors as the Commission deems appropriate" in making its rate recommendations.

Thus there is symmetry between both the Postal Service's obligations under section 3652 to demonstrate that all products complied with the applicable provisions of title 39, and the Commission's review under section 3653 which takes into account, among other things, the **policies of title 39.** Moreover, this reading is consistent with pricing under the PAEA which contemplates both ex ante and ex post review of prices.

Postal Service proposed price adjustments are subject to ex ante review by the Commission, including whether planned price changes are consistent with the policies of title 39. Commission determinations as to the lawfulness of such planned changes are, with notable exceptions, "provisional and subject to further review." See CFR 3010.13(j) and 39 CFR 3010.44(c). That further, ex post, review occurs in the ACD.

Standard Mail, as a class, covers attributable costs and makes a substantial contribution to institutional costs. However, FY 2010 ACR results show that the Standard Flats product does not cover costs, and therefore does not make a contribution to institutional costs. FY 2010 ACR at 31.

Beginning as early as the FY 2008 ACD and reiterated in subsequent proceedings, **the Commission expressed concern** that Standard Mail Flats do not cover costs and, as a consequence, impose a disproportionate institutional cost burden on other Standard Mail products, particularly Letters. FY 2008 ACD at 61; see also FY 2009 ACD at 86; Docket No. R2009-2, Order No. 191 at 52-53, and Docket No. R2010-2, Order No. 675 at 31. Since FY 2008, that burden has **worsened.** Flats' contribution per piece was **negative 2.2 cents** in FY 2008, growing to **negative 8.2 cents** in FY 2010. In contrast, the FY 2008 per-piece contribution from Standard Letters was a positive

9.0 cents and in FY 2010 was a positive 8.6 cents[53].... Despite the Commission's repeated suggestions that Flats be priced above cost (see, e.g., Order 191 at 53), the Postal Service has persisted in proposing below average price increases for this product, including in its most recent price adjustment proceeding, Docket No. R2011-2.

In this proceeding, three commenters (L.L. Bean, Valpak, and the Public Representative) address the Postal Service's repeated below-cost pricing strategy for Standard Flats (outside of the exigent case), including its most recent proposal in Docket No. R2011-2; discuss the ensuing harm, and point out the intra-class subsidy. They claim that the intra-class subsidy, amounting to $1.4 billion over the last three years, including $577 million in FY 2010, **violates 39 U.S.C. 101(d)**, which provides that postal rates "shall be established to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis." **The Commission agrees** and concludes that the **Standard Flats product is not in compliance** with this important policy of title 39. The Commission does not take this step lightly.... As discussed in Chapter VII, the Postal Service is directed, pursuant to section 3653(c), to take remedial action as promptly as practicable to effectively address the unfair and inequitable apportionment of costs....

Standard Mail Flats ... did not generate enough revenue to cover their attributable costs, and thus **added to the institutional cost burden of the Postal Service**.....

Standard Mail Flats continue to present a significant concern. Cost coverage for Standard Mail Flats was **81.6 percent**, with **a loss of 8.2 cents per piece**.... neither commercial flats nor nonprofit flats covered their costs, resulting in a cost coverage below 100 percent for the whole product.

The FY 2010 cost coverage for Standard Mail Flats is 81.6 percent, and the contribution per piece is negative 8.2 cents. ... [F]rom the time that the costs for the Flats Product have been separately reported in the CRA, **Flats' revenue has not covered its costs**.

The Commission stated its concern with the **growing intra-class cross subsidy** in previous ACDs and orders reviewing market dominant price adjustments. In the FY 2008 ACD, the Commission **recommended** that the Postal Service decrease the disparity between Standard Mail Flats and Letters in the next Market Dominant Price Adjustment or show that market characteristics or other non-cost factors justify continued unequal treatment.

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[53] An alternate way of viewing the burden is to compare the difference in unit contribution. In FY 2008, the difference in unit contribution was 11.2 cents, growing to 16.8 cents in FY 2010.

In Docket No. R2009-2, the Commission noted that the trend of below average increases for Flats in the recent price adjustments suggests a possible **pattern of preference contrary to sections 3622(b) and (c).**

In the **FY 2009 ACD**, the Commission found that the financial performance of this product **failed to satisfy section 3622(c)(2).** The Commission also found that the cost coverage issue:

> directly implicates the requirement of **section 101(d)**, which directs the Postal Service to apportion the costs of the Postal Service on a fair and equitable basis and section 3622(b)(5), which requires that rates must be set to ensure adequate revenues to maintain financial stability.

FY 2009 ACD at 86. The Commission **directed that the Postal Service devise a plan** to improve the cost coverage of the Flats product.

In Docket No. R2010-4, the Postal Service presented a plan to increase Flats prices and reduce costs that was estimated to achieve at least 100 percent cost coverage in **five years**. Key elements of that plan were: cost reductions, the 5.1 percent proposed Docket No. R2010-4 price increase, and increases for Flats of 2 percent above the change in CPI in the next five market dominant price adjustments. The Postal Service observed that it "has the flexibility under the PAEA to hold the overall increase for the class to CPI while combining below CPI increases for, say, Standard Mail letters with above CPI increases for Standard Mail flats." Docket No. R2010-4 Tr. 3/419-20.

In the FY 2010 ACR, the Postal Service states:

> [w]ith the Commission's denial of the Postal Service's exigent rate increase request in Docket No. R2010-4, the Postal Service's plan for bringing the fourteen products to full attributable cost coverage is no longer workable.... Therefore, it seems most appropriate for the Commission to determine whether it can exercise any of its powers to remedy the cost coverage shortfall of the products in question.
> FY 2010 ACR at 8....

The Commission has **repeatedly stated** that the Postal Service should use its intra-class pricing flexibility to reduce the cost coverage shortfall of Standard Flats. In Docket No. R2010-4, the Postal Service advanced a "**Flats Strategy**" designed to eliminate the Flats intraclass cross subsidy. In this proceeding, it summarized that document, stating "the Postal Service presented a detailed plan for capturing efficiencies for Standard Mail Flats that, when combined with consecutive above average price increases, would result in full attributable cost coverage." FY 2010 ACR at 8. The Postal Service now contends that, given the constraints of the PAEA, it is **impossible** to execute its "Flats Strategy" with respect to Standard Mail Flats. FY 2010 ACR at 8.

Valpak, the Public Representative, and L.L. Bean argue that the Postal Service has such pricing and operational flexibility. The Commission finds that PAEA permits the Postal Service sufficient operational and pricing flexibility to allow it to accomplish its

long-term goals for Standard Mail Flats as advanced in Docket No. R2010-4. **It has simply chosen not to utilize that flexibility** with respect to Standard Mail Flats. This is evidenced by its most recent price adjustment in Docket No. R2011-2, where the Postal Service utilized its pricing flexibility to increase Standard NFM/Parcel prices by an average of 11.3 percent in an attempt to reduce the cost coverage shortfall for that product.

As Table VII-17 shows, the **preferential price adjustments** accorded to Flats has led to an **increasingly negative contribution per piece**. Since the contribution of the Flats product was first reported in the CRA in FY 2008, the negative contribution per piece has **grown 279 percent from negative 2.2 cents per piece in FY 2008 to negative 8.3 cents in FY 2010.**

Valpak, the Public Representative, L.L. Bean, and Bank of America have stated that the long-running contribution shortfall for Standard Mail Flats is an **unfair and inequitable apportionment of costs in violation of 39 U.S.C 101(d). The Commission agrees.**

The Postal Service has lost $1.4 billion in contribution from Standard Mail Flats over the last three years, including $577 Million in FY 2010. This reflects an unfair and inequitable apportionment of the costs of postal operations to all Standard Mail users. The Commission has **repeatedly encouraged** the Postal Service to use its pricing flexibility to improve cost coverage for Standard Flats. Despite this encouragement, the Postal Service has **failed** to utilize the pricing flexibility granted to it by the PAEA to address this issue, and the negative contribution per piece continues to grow. Furthermore, the recently approved price changes are unlikely to improve cost coverage. For these reasons, the **Commission finds that the prices in effect in FY 2010 for Standard Flats do not comply with section 101(d) of title 39.**

Pursuant to section 3653(c), the **Commission directs the Postal Service to increase the cost coverage of the Standard Mail Flats** product through a combination of above-average price adjustments, consistent with the price cap requirements, and cost reductions until such time that the revenues for this product exceed attributable costs.

As embodied in the Postal Service's "Flats Strategy," above-CPI increases will be necessary to increase the cost coverage of the Flats product, and should be accompanied by efforts to streamline operations to capture efficiency and reduce costs. It is important for the Postal Service to control the costs of this product, which have increased by more than 15 percent on a per piece basis since FY 2008, compared to a CPI-U increase of just over 1 percent. The Commission expects the Postal Service to design future Flats prices that will comply with the factors and objectives of the PAEA, including the need to mitigate rate shock and to maintain predictable and stable prices.

In requiring the Postal Service to take **remedial action**, the Commission does **not impose a specific deadline**. However the Postal Service should move **as promptly as practicable** to eliminate this **inequity**. This process **must begin with the next market**

> **dominant price adjustment**. The Commission finds that, starting with the next Notice of Market Dominant Price Adjustment, the Postal Service must begin the process of transitioning Standard Flats prices to full cost coverage.
>
> **Within 90 days** of the issuance of the FY 2010 ACD, the Postal Service shall present a **schedule** of future above-CPI price increases for Standard Mail Flats. This schedule shall be updated with each subsequent Market Dominant Price Adjustment and ACR until the revenue of the Flats product exceeds its attributable cost.... Until such time, the Commission requires the Postal Service to provide the following information in Annual Compliance Reports and Notices of Market Dominant Price Adjustments to provide increased **transparency** concerning the steps the Postal Service is taking to eliminate the intra-class cross subsidy with respect to Standard Mail Flats.
>
> In **subsequent ACRs** the Postal Service shall report the following information:
>
> - describe all operational changes designed to reduce flat costs in the previous fiscal year and estimate the financial effects of such changes;
> - describe all costing methodology or measurement improvements made in the previous fiscal year and estimate the financial effects of such changes;
> - a statement summarizing the historical and current fiscal year subsidy of the Flats product; and, the estimated timeline for phasing out this subsidy.
>
> In **subsequent Notices of Market Dominant Price Adjustments**, the Postal Service shall report the following information:
>
> - an explanation of how the proposed prices will move the Flats cost coverage toward 100 percent, and
> - a statement estimating the effect that the proposed prices will have in reducing the subsidy of the Flats product. [FY 2010 ACD,[54] pp. 15-16, 102-07 (emphasis added).]

As the Commission noted, this was not the first time it had addressed this issue. Although the issue did not arise in the **FY 2007 ACD** because Flats data was not reported separately, the problem did get the Commission's attention in its FY 2008 ACD:

> The Commission is concerned with the $218 million loss for Standard Mail flats. As noted elsewhere in this report, the Postal Service suffered a $1.2 billion loss from products with a negative contribution during FY 2008. Of that loss, Standard Mail flats account for more than 20 percent. The **revenues** for Standard Mail flats in FY 2008 **failed to satisfy 39 U.S.C. § 3622 (c)(2)**, which requires that each class of mail or type of mail service cover attributable costs and make a reasonable contribution to

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[54] http://www.prc.gov/Docs/72/72382/PRC_ACD_2010.pdf

> institutional costs. For flats to cover FY 2008 cost, the rates of flats would have needed to be increased by 6.2 percent holding all other factors constant. The lack of a sufficiently high cost coverage **may be inconsistent with the policy** set forth in **39 U.S.C. § 101(d)** … which directs the Postal Service to apportion the costs of the Postal Service on a fair and equitable basis and 39 U.S.C. § 3622(b)(5), which states that rates must be set to ensure adequate revenues to maintain financial stability. [FY 2008 ACD, p. 61 (footnote omitted, emphasis added).]

Then, in its **FY 2009 ACD**, the Commission both addressed the problem and required the submission of a plan.

> For the reasons stated above, the Commission finds the rates for Standard Mail Flats **neither recover attributable cost** nor make a reasonable contribution to institutional cost. *The Commission finds that the appropriate action is for the Postal Service to* ***devise a plan*** *to improve the cost coverage of the Standard Mail Flats product. This plan should include any operational or mail preparation changes that the Postal Service deems necessary, as well as a specific timeline for achieving a positive contribution for the Standard Mail Flats product. The plan shall be included in the next ACR or the next general market dominant price adjustment, if it precedes the ACR.* In addition to adjusting prices and cutting costs, the Postal Service may consider changing the minimum qualifying volume for Carrier Route (from 10 to 6 piece bundles) to attract mail volume away from flats to the profitable Carrier Route flats category. The Postal Service could try a market test or a limited duration "mail preparation sale." [FY 2009 ACD, pp. 86-87 (italics original; bold added).]

B. The Postal Service's ACR Is Devoid of Meaningful Information about How the Postal Service Would Address the Problem of Standard Flats.

In its **current ACR**, the Postal Service spends little more than a page discussing the product that has caused a $652 million loss in FY 2011 alone, and fails to respond to the Commission's directions contained in the FY 2010 ACD — revealing that the Postal Service continues to turn a blind eye to this product's threat to the financial health of the entire Postal Service.

> The Standard Mail Flats product consists primarily of advertising flyers and catalogs that are demographically targeted. It is primarily used by businesses selling merchandise and for fundraising by nonprofit organizations. Like Standard Mail Letters it allows businesses to send existing or potential

> customers promotional material that does not require the most expeditious, and therefore, more expensive, mail processing and delivery. Consistent with these features, Standard Mail Flats prices are below the prices for First-Class Mail flats. **In FY 2010 the prices for Standard Mail Flats did not change.**
>
> Table 2 shows that the Flats product had a **cost coverage of 81.6 percent in FY 2010.** The Postal Service believes that **pricing and efficiency measures need to be taken** to ensure that this product covers its costs and makes an appropriate contribution toward institutional costs.... In the 2009 ACD, the Commission directed the Postal Service to present a **plan** describing how it intended to improve the cost coverage of this product.... The Postal Service presented its plans in its pricing statement in Docket No. R2010-4 and in its **flats strategy**, also filed in that docket....
>
> Standard Mail Flats are eligible for price discounts for presorting, prebarcoding and dropshipping. Mailers who do this extra work pay lower prices consistent with the costs their worksharing avoids for the Postal Service. In FY 2010 all discounts but four were less than or equal to their respective avoided costs. Worksharing in Standard Mail is discussed further in Section II.F of this report.
>
> The Standard Mail Flats product meets the need for a business-oriented, lower value, lower priced alternative to First-Class Mail. The Standard Mail Flats product is available to customers without undue discrimination, and promotes the policy goals of title 39. [FY 2010 ACD, pp. 30-31 (emphasis added).]

C. Standard Flats Lost an Additional $651.8 million in FY 2011, Pushing the Product's Four-Year Losses over the $2 Billion Mark.

In FY 2011, the Standard Flats product lost **$651.8 million**. With that loss, during the four years for which data are available, revenues from the Standard Mail Flats product have failed to cover attributable cost by a cumulative total of **$2.08 billion**. *See* Table IV-1. Even with a small decline in volume in FY 2011, losses on this product spiked to their highest level ever.

Table IV-1
Standard Mail Flats Revenue, Costs and Contribution
FY 2008 – 2011
($, millions)

Fiscal Year	Revenue	Attributable Cost	Contribution	Volume
2008	$3,663.7	$3,891.0	-$227.3	10,010.875
2009	2,866.0	3,488.3	-622.3	7,793.511
2010	2,579.4	3,161.3	-581.9	7,049.230
2011	2,491.1	3,142.9	-651.8	6,783.186
TOTAL	$11,600.2	$13,683.5	-$2,083.3	

Source: CRA for each respective year.

Table IV-2 shows the unit revenues, costs, and contribution of Standard Flats for FY 2009-2011.[55] The unit cost has been resistant to cost-cutting efforts, despite continuing deployment of the Flats Sequencing System ("FSS") machines, the Flats Strategy, and all other efforts. Since cost cutting has not worked, it is even more important for Commission-directed price increases to be implemented. Otherwise, continued large losses on Flats can be anticipated by the Postal Service, as well as by mailers of other profitable products who subsidize those losses — or by recipients who may be forced to suffer reductions in service, such as closure of thousands of post offices, and cessation of 6-day delivery, second-day

[55] The Postal Service's Cost and Revenue Analysis ("CRA") report began providing data on the Standard Mail Flats product in FY 2008, but even before then separate cost and revenue data were available for flats, and from those data flats profitability could be determined. The Standard Mail Flats product is — obviously — exclusively flats, while the Carrier Route Letters, Flats, and Parcels product is almost exclusively (over 97 percent) flat-shaped pieces (*i.e.,* catalogs). No evidence has been located demonstrating that what is now the Flats product has ever been profitable, but the problem long has avoided much attention. From testimony submitted in Docket No. R2006-1, it appears that Flats then were deeply underwater. *See* Docket No. R2006-1, testimony of Robert W. Mitchell, VP-T-1, pp. 160, 196, and supporting workpapers (tab INPUTS and Current-1).

delivery in lieu of overnight delivery, etc. It is not fair or equitable for mailers of other profitable products (some of which compete with Standard Flats catalogs) or recipients to be required to continue subsidizing Flats' catalog mailers — particularly at 8.3 cents for each catalog sent.

Table IV-2
Standard Flats Unit Revenue, Cost and Contribution
FY 2009 – 2010

Fiscal Year	Revenue	Attributable Cost	Contribution
2009	$0.368	$0.448	-$0.080
2010	$0.366	$0.448	-$0.083
2011	$0.366	$0.448	-$0.083

Source: CRA for each respective year.

D. No Plan Has Ever Been Developed by the Postal Service to Decrease the Cost of Handling Flat-Shaped Products and Increase Rates.

After the Commission issued its FY 2010 ACD on March 29, 2011, the Postal Service filed a motion[56] to avoid filing the schedule on May 17, 2011, as directed by the Commission. Valpak opposed that motion on May 24, 2011,[57] fearing that it would result in further delay in obtaining an end to the subsidies, but the motion was granted on May 27, 2011, the Commission stating that "[i]n reaching this conclusion, the Commission emphasizes that it remains committed to Standard Mail rates that conform with 39 U.S.C. 101(d)…."[58]

56 http://www.prc.gov/Docs/72/72924/Mot.Stay.ACD..pdf

57 http://www.prc.gov/Docs/73/73035/VP%20Answer.pdf

58 http://www.prc.gov/Docs/73/73096/Order_No_739.pdf

Therefore, as of today, the only Postal Service plan for reducing the cost of handling flats (including Periodicals) was submitted by the Postal Service in the exigent rate case (Docket No. R2010-4), which consisted largely of a series of vague, unsupported statements about various ongoing or contemplated initiatives that might decrease costs by some unspecified amount. In no way did this submission constitute a plan specifically aimed at improving coverage of Standard Flats. Rather, it contained only one initiative directed explicitly to reducing the cost of handling flats generally — the ongoing installation of the FSS.

Regrettably, the plan in Docket No. R2010-4 provided no meaningful information concerning the potential for cost reduction from FSS, despite explicit prior criticism by the Commission in its FY 2009 ACD.[59] The so-called "plan" failed to provide any meaningful information either as to timing or the extent of specific initiatives that might be expected to reduce flats costs and bring Standard Flats coverage into compliance. In Docket No. ACR2010, the Postal Service stated, without elaboration, that its "plan" to bring Standard Flats and Periodicals to full cost coverage "is no longer workable." *Id.*, p. 8. The ACR alluded to difficulties in reducing the cost of handling flat-shaped mail as follows:

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[59] With respect to FSS, the Commission's FY 2009 ACD stated: "For example, Intelligent Mail barcode, **Flats Sequencing System**, and Network Distribution Centers, all major Postal Service initiatives that could be fairly characterized as program activities, are either **not detailed** fully, **lack specificity** as to performance goals and a basis for comparing results with goals, or are **not addressed at all** in terms of performance plans.

"The discussion of **FSS** is illustrative.... **No information is provided quantifying the intended benefits of FSS** or the progress made towards achieving those intended benefits. According to section 2803, in the absence of quantification or measurement, a description of a minimally effective or successful program is to be provided. **No such description by which an assessment of the FSS program can be made is offered**. Even at high level categories such as processing, transportation, or delivery there is no quantification or method for measurement." FY 2009 ACD, p. 45 (emphasis added).

> As the Postal Service has indicated to the Commission over the course of their joint work on the Periodical Study, even if the Postal Service achieves the **most optimistic efficiency enhancements possible,** it does **not foresee** that such enhancements, combined with annual rate increases within the statutory price cap, will result in Periodicals, **Standard Mail Flats**, and Standard Mail NFMs/Parcels reaching **full attributable cost coverage**. [FY 2010 ACR, p. 8 (emphasis added).]

Thereafter, the Postal Service filed a Petition for Review in the U.S. Court of Appeals for the District of Columbia. That case is now pending as No. 11-1117, with oral argument scheduled for February 7, 2012. The two large users of Standard Mail who had urged the Commission to make its finding of noncompliance — intervenors L.L. Bean and Valpak — filed a joint brief in the Court of Appeals supporting the Commission's legal authority to make a finding of noncompliance and enter a remedial order.[60] The American Catalog Mailers Association filed a brief opposing the Commission's role and defending continued subsidies for Standard Flats.

In some ways, the Postal Service's challenge to the Commission's authority was remarkable. In its FY 2010 ACR, the Postal Service had invited the Commission to determine its authority to remedy the situation:

> it **seems impossible** for the Postal Service, acting with the powers granted to it and within the constraints imposed by title 39, to present any realistic plan that would result in these products fully covering their attributable costs, much less making any contributions to institutional costs. Therefore, **it seems most appropriate for the Commission to determine** whether it can exercise any of its **powers** to remedy the cost coverage shortfall of the products in question. [*Id.*, pp. 8-9 (emphasis added).]

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[60] http://lawandfreedom.com/site/postal/LLBean-Valpak_Brief.pdf

When the Commission did as the Postal Service requested, the Postal Service changed its mind and challenged the Commission's decision.

E. The Postal Service's Filing Failed to Comply with the Commission's Directions in Its FY 2010 ACD.

Since cost controls have totally failed, consecutive above-average price increases are the most obvious way to increase coverage for an underwater product like Standard Flats. PAEA gives the Postal Service significant flexibility and latitude when setting prices for market dominant products within profitable classes. Table IV-3 compares price adjustments for Standard Flats with the average price adjustment for all Standard Mail. Clearly, for Standard Flats there have been no consecutive price increases significantly above average.

Table IV-3
Standard Mail and Standard Flats Percentage Price Increase

Docket No.	Standard Flats	Standard Mail
R2008-1	0.865%	2.838%
R2009-2	2.306%	3.781%
R2010-4 (rejected)	5.134%	5.616%
R2011-2	0.835%	1.739%
R2012-3	2.209%	2.124%

In the price adjustment notice filed October 18, 2011, which became effective January 22, 2012, the Postal Service made sport of the Commission's direction by noticing a price increase for Standard Flats that technically, but barely, exceeds the percentage price increase

for all Standard Mail — by 0.085 percent. *See* Docket No. R2012-3, United States Postal Service Notice of Market Dominant Price Adjustment, p. 18.[61] Of the last five proposed rate increases, this was the first one that at least raised Standard Flats rates as high as the average for all Standard Mail products. The cumulative effect of the four implemented rate increases shown in Table IV-3 is **6.4 percent** for Standard Flats versus **10.9 percent** for all Standard Mail.[62]

Still, the Postal Service ignored the specific Commission direction that, in subsequent ACRs, the Postal Service would report certain information about (i) operational changes, (ii) changes in costing methodology, and (iii) a statement of the extent of the subsidy and a timeline for phasing it out. FY 2010 ACD, p. 107. When the Commission allowed the Postal Service to defer the schedule that it had required be filed in 90 days, it never waived these requirements. It distinguished between the "general remedial action" which was not waived, and "specific remedial action," defined as "the requirement that the Postal Service present a schedule of above-CPI price increases for Standard Mail Flats within 90 days." Order No. 739, p. 2.[63] There was no stay of the requirement that the information identified by the Commission in its FY 2010 ACD be filed by the Postal Service in its ACR, as follows:

> In **subsequent ACRs** the Postal Service **shall report** the following information:

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[61] http://www.prc.gov/Docs/76/76795/Notice%20of%20Rate%20Adjustment%20Final.pdf

[62] This excludes Docket No. R2010-4.

[63] http://www.prc.gov/Docs/73/73096/Order_No_739.pdf

- describe all operational changes designed to reduce flat costs in the previous fiscal year and estimate the financial effects of such changes;
- describe all costing methodology or measurement improvements made in the previous fiscal year and estimate the financial effects of such changes;
- a statement summarizing the historical and current fiscal year subsidy of the Flats product; and, the estimated timeline for phasing out this subsidy. [FY 2010 ACD, p. 107 (emphasis added).]

Yet again, the Postal Service has refused to comply with the Commission's directives regarding Standard Flats, as this information was not provided.

If and when the U.S. Court of Appeals for the District of Columbia reaffirms the Commission's authority to make a finding of noncompliance and issue remedial orders, the Commission should move quickly to direct that a substantial increase be made in Standard Flats rates, moving them toward full cost coverage plus a reasonable contribution to institutional costs in no more than three years.

V. THE PERIODICALS CLASS CONTINUED TO BE UNDERWATER DURING FY 2011 — FOR THE 15TH CONSECUTIVE YEAR — FALLING TO THE LOWEST COVERAGE EVER RECORDED FOR A MAIL CLASS.

A. Periodicals Continued Losing Money in Record Amounts During FY 2011.

The FY 2011 ACR reveals that the Periodicals class continues its 15-year run of consistently losing massive amounts of money for the Postal Service, resulting in it being heavily subsidized. The Periodicals class lost **$611 million** in FY 2011, driving up the class's

cumulative deficit to almost **$5 billion** over that 15-year period.[64] Under PAEA, annual losses have not improved; instead they have escalated.[65] Over **$2.7 billion** has been lost on Periodicals in the five short years since enactment of PAEA, preceded by more than the $2.2 billion loss in the 10 years before PAEA. *See* Table V-1.

Despite wishful thinking, the financial hemorrhage clearly is getting worse, not better, as coverage for the Periodicals class now has dropped to a new **all-time low of 74.94 percent**. This is the lowest coverage of any class of mail in memory.

The Postal Service candidly admits that the Periodicals class is in violation of the requirement of 39 U.S.C. section 3622(c):

> As discussed above, Periodicals' cost coverage continues to present a challenge to the Postal Service and mailers, since **the Periodicals class does not satisfy section 3622(c)(2)** of title 39. [FY 2011 ACR, p. 33.]

The Postal Service then informs the Commission that the situation now appears to be hopeless — that no pricing change can fix the problem — perhaps even suggesting that no steps should be taken to improve the situation:

> Further, publishers face increasing competition from electronic media, typically low profit margins, and the generally poor economic climate. Even **if** it were possible under the statute to

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[64] To put the one-year loss of $611 million on Periodicals into perspective, it is nearly the total net income of **Amazon.com** in 2011 ($631 million). To put this cumulative loss from Periodicals into perspective, $5 billion is almost equal to the tangible net worth of **United Parcel Service** at the end of 2010 ($5.3 billion).

[65] This is in contrast to one of the Commission's reasons for not finding Periodicals out of compliance in its FY 2010 ACD. "First, concerns about Periodicals cost coverage existed in the years prior to the PAEA; they are not a recent development." FY 2010 ACD, p. 17. The **accelerated loss** under PAEA is a "recent development."

> **increase prices to cover all costs**, according to publishers, the resulting prices would drive many out of the print business altogether and speed migration to electronic alternatives. In this event, because of the drop in overall volume, it seems **likely that revenues would remain below costs**. [FY 2011 ACR, p. 33 (emphasis added).]

The Postal Service's assertion that price increases would not work for the Periodicals class does not withstand analysis. The Postal Service apparently believes that significantly increasing prices for Periodicals, as would be required to cover attributable costs, could never result in revenues covering costs. The Postal Service's statement could be interpreted as inferring that it believes that the costs which it regularly measures and reports to the Commission as attributable are not truly volume variable, implying that neither the cost nor the losses could be reduced if it were faced with a substantial decline in the volume of Periodicals.[66] The Postal Service's experience in wringing costs out of the system in the face of declining volumes has already demonstrated that volume variable costs are truly variable, albeit with a lag.[67] Any implied hopelessness inherent in the Postal Service's position must be rejected. A significant increase in coverage of the Periodicals class is both feasible and urgently needed to make up for past delays that have served only to worsen the situation.

The Postal Service explains that it is (finally) considering adjusting the Periodicals price structure to "signal the appropriate level of cost-reducing behavior," and researching "bundle

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[66] Only 58.8 percent of this year's costs are considered attributable, or volume variable, a relatively low level of attribution. USPS-FY11-02 (Cost Segments and Components), Tab: CS Summary.

[67] *See* discussion of Postal Service cost cutting, Docket No. ACR2010, Valpak Initial Comments (Feb. 2, 2010), pp. 38-40.

and container 'cost passthroughs,'" admitting that "[t]his inquiry has been encouraged by the Commission's findings in the FY 2010 ACD." FY 2011 ACR, pp. 33-34. The Postal Service fails to mention, however, that for years it largely has disregarded this same, consistent advice of the Commission.[68]

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[68] In the most recent rate adjustment (reviewed in Docket No. R2012-3), the Postal Service raised coverage on pallets, the containers least costly and most efficient to handle, while constraining the coverage on bundles and sacks, which are most costly to handle. The rate adjustment thus fails to provide Periodicals mailers with improved price signals.

Table V-1
Periodicals Class — Revenue, Cost, Coverage, and Cross-Subsidies
FY 1997 — 2011

	(1)	(2)	(3)	(4)
PRC CRA	Revenue	Costs	Cover-age	Revenue – Costs
Year	($, mill.)	($, mill.)		($, mill.)
Under PAEA				
2011	1,821.1	2,430.0	74.94%	-608.9
2010	1,878.8	2,489.8	75.46%	-611.0
2009	2,038.0	2,680.0	76.04%	-642.0
2008	2,294.9	2,732.1	84.00%	-437.2
2007	2,187.9	2,635.6	83.01%	-447.7
Subtotal	**10,220.7**	**12,697.5**	**78.82%**	**-2,746.8**
Under PRA				
2006	2,124.8	2,487.6	85.42%	-362.8
2005	2,068.9	2,431.6	85.08%	-362.7
2004	2,100.0	2,323.3	90.39%	-223.3
2003	2,139.6	2,196.2	97.42%	-56.6
2002	2,066.9	2,280.4	90.64%	-213.5
2001	2,106.9	2,367.1	89.01%	-260.2
2000	2,076.3	2,354.8	88.17%	-278.5
1999	2,017.7	2,213.1	91.17%	-195.4
1998	1,972.8	2,129.0	92.66%	-156.2
1997	1,964.6	2,038.5	96.37%	-73.9
Subtotal	**20,638.5**	**22,821.6**	**90.43%**	**-2,183.1**
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TOTAL	**30,859.2**	**35,789.1**	**86.23%**	**-4,929.9**

B. Periodicals under PAEA (FY 2007 – FY 2009).

In its comments during prior annual compliance reviews, Valpak repeatedly has discussed the problem raised by the entire Periodicals class failing to cover attributable costs in each ACR docket since enactment of PAEA.[69] Rather than take remedial action, the Commission has hoped for the best and "kicked the can down the road" for the past four years. In each ACD, the Commission has found a reason to avoid taking action.

In its **FY 2007** ACD, the Commission stated:

> In addition to increasing efficiencies, the rates implemented in July 2007, were designed to generate a very substantial increase in revenue. The recent further **rate increases** approved for the Periodicals class in Docket No. R2008-1 reasonably approximate the allowable CPI cap. At this point in time, it is most appropriate to allow the recently adopted **strategy** for overcoming the Periodicals **revenue-cost relationship** a **reasonable interval of time** to succeed. [FY 2007 ACD, p. 70 (emphasis added).]

In its **FY 2008** ACD, the Commission stated:

> Results for the past fiscal year clearly show that Periodicals remain, in the Postal Service's words, "a challenged class" in terms of cost coverage. The need to bring Periodicals revenues into closer alignment with attributable costs is not simply a matter of achieving technical **compliance** with PAEA requirements for this class, but also of fostering broader assurances of **systemwide financial stability** and **fairness to other mailers**.
>
> Both of these considerations highlight the **imperative need** to reduce the extent to which Periodicals are exposed to manual sorting operations, to control other costs, to improve cost modeling, to align the pricing structure more closely with cost

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[69] *See* Docket No. ACR2010, Valpak Initial Comments, pp. 32-40, setting forth the history of Valpak's comments about Periodicals and the Commission's decisions regarding the ACRs for FY 2007, FY 2008, and FY 2009.

> incurrence, and to employ pricing objectives that also send **clear signals to mailers**. Toward these ends, *the Commission anticipates exploring the feasibility and impact of including allied piece costs in worksharing cost. It supports and encourages the* ***Joint Task Force*** *effort to improve the data used in the Periodicals cost model, to search for practices that will improve operational efficiency handling and transporting Periodicals, and to consider whether the discount or rate structure can help the Postal Service and its customers to become more efficient users of the mail. It also strongly encourages the Postal Service and Periodicals mailers to consider administrative solutions to processing decisions that currently elevate service decisions over cost considerations*. [FY 2008 ACD, pp. 58-59 (italics original; bold added).]

In its **FY 2009** ACD, the Commission stated:

> In considering various options, the Commission is persuaded that the best course, under the circumstances, is to **await** the issuance of the **Joint Report** before addressing Periodicals rates in specific detail. The Commission is **hopeful** that the report, which it **anticipates will be issued shortly,** will provide helpful guidance in this area. There are, as discussed below, current opportunities for the Postal Service to improve Periodicals cost coverage by **modifying** container and bundle **passthroughs**.
>
> *The Postal Service shall develop and present a* ***plan*** *explaining how it intends to* ***increase Periodicals cost coverage to a reasonable level*** *in its next notice of general price adjustments for market dominant products, or its next annual compliance report*. [FY 2009 ACD, p. 75 (italics original; bold added).]

C. FY 2010 Annual Compliance Determination.

After last year's review, the Commission agreed with the Postal Service that the Periodicals class rates were in violation of 39 U.S.C. section 3622(c)(2) (*see* FY 2010 ACD, p. 90), but nevertheless concluded that the Periodicals class was not "out of compliance with applicable provisions of chapter 36 or regulations promulgated thereunder." FY 2010 ACD, p. 17.

Last year, the Commission discussed potential solutions on the "cost side" and the "pricing side." On the **cost side**, the Commission held out high hopes for reductions as a result of (i) the Postal Service's "Flats Strategy" submitted with the exigent price request in Docket No. R2010-4, and (ii) the (then) "forthcoming Periodicals Study Report" (which finally was issued in September 2011).

On the **pricing side**, the Commission determined that it would not "order prices … be increased beyond the statutory cap," because, in part, "the Postal Service does not have the same discretion to set prices substantially above the price cap that it has with respect to products within Standard Mail." FY 2010 ACD, p. 94. Additionally, it stated that "there is room for improvement in worksharing discounts and in the prices for bundles and containers [in order to] create additional incentives for mailers to prepare mail more efficiently." *Id.*

In conclusion, the Commission stated: "Recognizing that [39 U.S.C. section 3622(c)(2)] is one of 14 factors that must be taken into account, the Commission agrees [with the Postal Service that section 3622(c)(2) was not satisfied] and recommends that the Postal Service pursue the opportunities explored above and in the Periodicals Study to reduce the costs of handling flats." *Id.*

With respect to the **Standard Mail Flats** product for FY 2010, the Commission found noncompliance, and ordered remedial action on the part of the Postal Service,[70] but

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[70] As discussed in Section IV, *supra*, the Commission's determination with respect to Standard Flats is currently the subject of a petition for review in the U.S. Court of Appeals for the D.C. Circuit.

distinguished its active approach to that product with its passive approach to the Periodicals class:

> First, concerns about Periodicals cost coverage existed in the years **prior to the PAEA**; they are not a recent development. Second, unlike Standard Mail, Periodicals as a **class** fails to cover costs. While this is a concern, there is no suggestion that the Postal Service has ignored its **pricing flexibility** under the PAEA with respect to Periodicals products. Lastly, management has not yet fully brought to bear efficiency enhancements, network adjustments, and related changes which could alter the attributable cost picture for Periodicals. The Commission believes it is appropriate **to allow time** for these measures to be implemented and take hold. [FY 2010 ACD, p. 17.]

D. Previous Rationales for Deferring Action on Periodicals Are No Longer Available.

1. The Cost Side: the Flats Strategy and the Periodicals Mail Study Confirm that the Postal Service Cannot Cut Enough Costs to Make Periodicals Profitable.

In its FY 2010 ACD, the Commission cited two reports (discussed in Section III.B, *supra*), each of which now confirms that there are not enough cost-cutting strategies in the known world that alone ever will return Periodicals to a status where it covers its costs (much less make some small contribution towards institutional costs).

(i) With the Postal Service's exigent rate request, Docket No. R2010-4, the Postal Service provided its so-called "**Flats Strategy**" in response to the Commission's FY 2009 ACD. That ACD required the Postal Service to "develop and present a plan explaining how it intends to increase Periodicals cost coverage to a reasonable level…." (FY 2009 ACD, p. 75 (italics removed).) Only two parts of that plan were supported by more than mere conjecture: (i) the Flats Sequencing System and (ii) an above-CPI

price increase. In its FY 2010 ACR, the Postal Service confirmed that cost-cutting strategies contained in the Flats Strategy alone would not return Periodicals to compliance with section 3622(c)(2):

> As the Postal Service has indicated to the Commission over the course of their joint work on the Periodical Study, even if the Postal Service achieves the **most optimistic** efficiency enhancements possible, it does **not foresee** that such enhancements, combined with annual rate increases within the statutory price cap, will result in Periodicals, Standard Mail Flats, and Standard Mail NFMs/Parcels reaching **full attributable cost coverage**. In other words, it **seems impossible** for the Postal Service, acting with the powers granted to it and within the constraints imposed by title 39, to present any realistic plan that would result in these products fully covering their attributable costs, much less making any contributions to institutional costs. [FY 2010 ACR, pp. 8-9.]

(ii) The **Periodicals Mail Study** also confirms that the potential cost savings identified in that report are insufficient for Periodicals to cover costs:

> The Postal Service and Commission also agree that opportunities for increasing operational efficiency exist. Although the Postal Service and the Commission use different methodologies to estimate the cost savings available through operational changes, the difference in cost savings estimates is one of degree. Regardless of approach, there will still be a **cost coverage gap**; **without price changes** or legislative changes, Periodicals will not be able to cover its costs. [Periodicals Mail Study, p. 91 (emphasis added).[71]]

In the Periodicals Study, the Postal Service provided a detailed explanation why processing of Periodicals differs from that for Standard Mail, and why the cost of handling Periodicals is never likely to be brought down to the cost of handling Standard Flats. The

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[71] *See* discussion in Section III, *supra*.

Postal Service estimates that the **maximum annual cost savings** that can be achieved for Periodicals, under optimum conditions, is $146 million, which is **less than one-fourth of this year's shortfall** of $609 million. *See* Periodicals Mail Study, pp. 95-96.

None of the Commission's cost-side reasons to defer action is available to it in this docket. In fact, the impossibility of ever solving the issue through cost reductions alone makes an above-cap rate increase all the more imperative.

2. The Pricing Side: A Realignment of Workshare Discounts and Prices for Bundles and Containers Will Not, in and of Itself, Enable Periodicals to Cover Costs in the Short Term.

The Commission was correct to address the pricing side of Periodicals. Indeed, pricing is the core of the Commission's authority, as the Commission has no direct power over Postal Service costs under 39 U.S.C. section 3662. Its authority instead consists of ordering action "to achieve compliance" and "to remedy the effects of noncompliance." The statutory examples of remedies include adjusting rates to lawful levels and discontinuing loss-making products. *See* 39 U.S.C. § 3662(c).

Although the Commission has suggested correctly that there was "room for improvement in worksharing discounts and in the prices for bundles and containers,"[72] neither the Postal Service nor the Commission has claimed that such pricing improvements will be

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[72] FY 2010 ACD, p. 92. The Commission recommended in both its FY 2009 ACD and FY 2010 ACD that the Postal Service should improve worksharing discounts and bundle/container prices. *See* FY 2010 ACD, p. 94. Yet in its FY 2011 ACR, the Postal Service acts as if the FY 2010 ACD was the first time it was ever raised, when it states: "the Postal Service is focusing pricing research on bundle and container 'cost passthroughs'.... This inquiry has been encouraged by the Commission's findings in FY 2010 ACD." FY 2011 ACR, pp. 33-34.

sufficient to return Periodicals to covering its costs. As noted above, the Periodicals Study stated categorically that the Postal Service and the Commission are in agreement that price changes will be needed in order for the Periodicals class to cover costs.

In Docket No. ACR2010, the Commission noted that "the Postal Service does not have the same discretion to set prices substantially above the price cap that it has with respect to products within Standard Mail" (FY 2010 ACD, p. 94). Yet the Commission dismissed the most meaningful pricing remedy in light of all the other "considerations," and decided it "need not address the scope of remedial powers under section 3653." FY 2010 ACD, p. 17. It did not deny such power, only that it was "not persuaded … that it should order prices to be increased" in that docket. *Id.*, p. 94. This year it has yet another opportunity to order remedial action.

E. The FY 2011 Periodicals Prices Are Not in Compliance.

In Docket No. ACR2010, the Postal Service forthrightly admitted, and the Commission found, that Periodicals prices are not in compliance with 39 U.S.C. section 3622(c)(2). *See* FY 2010 ACD, p. 94. The Postal Service has made this admission again in this docket. *See* FY 2011 ACR, p. 33.

The Commission apparently declined to remedy the problem for the reason that section 3622(c)(2) was only "one of 14 factors that must be taken into account." FY 2010 ACD, p. 94. It stated: "[i]n making its determination, the Commission must take into account numerous sometimes conflicting considerations." *Id.*, p. 17. The Commission was not specific about the source of the perceived conflict. Accordingly, these comments will review

all of the numerous statutory considerations (Objectives, Factors, and Requirements) to reveal the degree of conflict with section 3622(c)(2), if any.

39 U.S.C. section 3622 describes the "modern system for regulating rates" required by PAEA, as being based on certain Objectives, Factors, and Requirements.

1. "(b) Objectives. — Such system shall be designed to achieve the following objectives, each of which shall be applied in conjunction with the others:"

"(1) To maximize incentives to reduce costs and increase efficiency."

As identified by the Commission in its FY 2010 ACD, "there is room for improvement" for creating "incentives for mailers to prepare mail more efficiently." Thus, Periodicals prices cannot be said to be in compliance with this section. Certainly this does not speak against an above-cap pricing increase.

"(2) To create predictability and stability in rates."

The Postal Service's rates could not be said to be maintaining predictability in rates, nor should the failure to cover costs be viewed as maintaining stability. At some point, rates for Periodicals are going to have to be fixed so as to increase cost coverage. Congress may impose this increase more rapidly than the Postal Service and the Commission would want. Not knowing when the "other shoe will drop" makes the rates ultimately unpredictable and unstable.

"(3) To maintain high quality service standards established under section 3691."

Rather than conflicting with subsection (c)(2), the failure to cover costs contributes to the financial deficit that is forcing Postal Service initiatives designed to

reduce service standards for all mailers as well as recipients. *See generally* Docket No. N2012-1.

"(4) To allow the Postal Service pricing flexibility."

Regardless of whether the Postal Service has fully utilized its pricing flexibility to adjust rates within Periodicals so as to provide those mailers with price signals that better reflect costs, the Postal Service's pricing flexibility is limited by the cap. The Commission observed in the FY 2010 ACD that "the Postal Service does not have the same discretion to set prices substantially above the price cap that it has with respect to products within Standard Mail." FY 2010 ACD, p. 94. Only the Commission can increase rates beyond the cap. 39 U.S.C. § 3662(c). Thus there is no inconsistency here.

"(5) To assure adequate revenues, including retained earnings, to maintain financial stability."

Rather than being conflicting with subsection (c)(2), this objective clearly supports an above-the-cap price increase. *See* Section I, *supra*.

"(6) To reduce the administrative burden and increase the transparency of the ratemaking process."

Not conflicting with subsection (c)(2).

"(7) To enhance mail security and deter terrorism."

Not conflicting with subsection (c)(2).

"(8) To establish and maintain a just and reasonable schedule for rates and classifications…."

A just and reasonable schedule does not mandate a cost coverage of less than 100 percent. The coverage for Periodicals was 74.94 percent in FY 2011. A coverage of less than 100 percent is neither fair nor just to other mailers, nor can continued erosion of coverage below 100 percent be viewed as maintaining a reasonable rate schedule. Continued losses that force the Postal Service to reduce services, *e.g.*, elimination of Saturday delivery and closure of post offices, also are unfair for recipients. There is not only no conflict, but support for higher prices.

"(9) To allocate the total institutional costs of the Postal Service appropriately between market-dominant and competitive products."

Rather than conflict with subsection (c)(2), Periodicals might be violating this objective if it is causing competitive products to pay an inappropriately high allocation than otherwise would be required.

2. "(c) Factors. — In establishing or revising such system, the Postal Regulatory Commission shall take into account —"

"(1) the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to the collection, mode of transportation, and priority of delivery."

Not conflicting with subsection (c)(2). Many Periodicals receive much better service than Standard Mail and Package Services.

"(2) the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail

service through reliably identified causal relationships plus that portion of all other costs of the Postal Service reasonably assignable to such class or type."

Valpak agrees with both the Postal Service and the Commission that Periodicals prices are not in compliance with this factor.

"(3) the effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters."

This is one factor that clearly could be said to be "conflicting" with factor (2) in a meaningful way. In other classes, however, this factor historically has been interpreted to suggest that higher-than-average increases be phased in, rather than imposed all at once. To the extent that other mailers are now being forced to subsidize Periodicals, the other side of the coin is that raising rates for Periodicals would affect all mailers favorably, other than Periodicals mailers.

"(4) the available alternative means of sending and receiving letters and other mail matter at reasonable costs."

The content of Periodicals mail has alternative means of delivery, and many publications have been migrating to electronic media, but the Postal Service calculates a relatively low elasticity for the Periodicals products (formerly subclasses). *See* Demand Models filed with the Commission on January 20, 2012. Even if this were a "conflicting" factor, it would be relatively insignificant for the Periodicals class.

"(5) the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service."

Not conflicting with subsection (c)(2).

“(6) simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services.”

Not conflicting with subsection (c)(2).

“(7) the importance of pricing flexibility to encourage increased mail volume and operational efficiency.”

The term “pricing flexibility” is employed by the Postal Service as if it were the second most important element of the “modern system for regulating rates” in PAEA, right behind the price cap in section 3622(d). According to this factor in PAEA, pricing flexibility has importance for two reasons: to encourage (i) increased mail volume, and (ii) operational efficiency. Despite the Commission’s admonishment that “there is room for improvement” to create “incentives for mailers to prepare mail more efficiently,” the FY 2010 ACD stated “there is no suggestion that the Postal Service has ignored its pricing flexibility.” FY 2010 ACD, pp. 15, 94. Of course, there is not much “pricing flexibility” available for Periodicals because of its failure to cover costs by such a wide margin.

“(8) the relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail.”

Not conflicting with subsection (c)(2).

“(9) the importance of providing classifications with extremely high degrees of reliability and speed of delivery and of providing those that do not require high degrees of reliability and speed of delivery.”

Not conflicting with subsection (c)(2).

“(10) the desirability of special classifications....”

Not conflicting with subsection (c)(2).

"(11) the educational, cultural, scientific, and informational value to the recipient of mail matter."

This factor requires that Periodicals be given a lower markup over cost than other products because of the value of its content. In other words, Periodicals should provide a smaller percentage **contribution to institutional costs** than other classes, but this does not mean that this class should be subsidized — at any level. Nothing in the PRA or PAEA sanctions continued subsidization of the Periodicals class in perpetuity. To the extent that this factor requires Periodicals to make a relatively low contribution, it in no way "conflicts" with subsection (c)(2).

"(12) the need for the Postal Service to increase its efficiency and reduce its costs, including infrastructure costs, to help maintain high quality, affordable postal services."

Naturally, the Postal Service should not incur unnecessary costs and expect ratepayers (or taxpayers) to cover all costs. The need to reduce costs is in conflict with subsection (c)(2) when there are costs that can be reduced. However, as noted above, the Postal Service and the Commission agree that Periodicals costs cannot be reduced sufficiently for that class to break even.

"(13) the value to the Postal Service and postal users of promoting intelligent mail and of secure, sender-identified mail."

Not conflicting with subsection (c)(2).

“(14) the policies of this title as well as such other factors as the Commission determines appropriate.”

Just as the Commission determined that Standard Mail Flats was not in compliance with 39 U.S.C. section 101(d) in FY 2010, Periodicals obviously does not carry a fair and equitable (or any) portion of the “costs of all postal operations.” They are, therefore, not in compliance with factor (14), as incorporating 39 U.S.C. section 101(d) as the Commission determines appropriate, and there is no conflict with subsection (c)(2).

3. “(d) Requirements.”

As Periodicals’ price increases have not exceeded the price cap authority, Periodicals is not in violation of this provision. Although the Commission has determined the price cap has primacy over **individual** objectives and factors (*see* FY 2010 ACD, pp. 18-19), it has not explored the scope of its authority to make a determination of noncompliance when a product or class is not in compliance with **numerous** objectives and factors. Moreover, certainly when prices violate 39 U.S.C. section 101(d), the Commission understands that it is required to take action. *See, e.g.*, FY 2010 ACD, p. 105 (regarding Standard Mail Flats).

In summary, the Periodicals class could be found out of compliance with at least 11 of the 24 objectives, factors, and requirements. Additionally, it appears that only two, factor (3) and the price cap, have any meaningful conflict with the cost coverage requirement of factor (2). Any determination by the Commission deferring action on Periodicals should explain which subsection of section 3622 overrules the need for Periodicals to cover more of its costs.

F. Periodicals' Price and Service.

Postal Service financial difficulties have been brought on in no small part by continuing deficits on underwater products, of which Periodicals has been the worst offender. For many years, those publications have received a quality of service that far exceeds cost. Continued losses are now forcing the Postal Service to initiate proposals for across-the-board service reductions that apply to Periodicals — *e.g.*, eliminate Saturday delivery for all products, and eliminate next-day delivery for those publications in Periodicals that historically also have received next day delivery (*e.g.,* small in-county newspapers that publish six days a week, and news weeklies such as *Time* or *Business Week*). If circulation of those publications now suffers because of deficit-induced service reductions, Periodicals should not be heard to complain.

In Docket No. N2011-1, it was estimated that closure of all 3,600 retail facilities proposed for study would save the Postal Service about $200 million per year. Cost reductions to offset the annual loss on Periodicals, now just over $600 million per year, might be achieved by closing at least twice as many smaller post offices, *i.e.*, 7,200, or more. If the Commission continues to delay with respect to (i) improving coverage of the Periodicals class and (ii) its responsibility to help assure adequate revenues and retained earnings, then it should embrace enthusiastically expeditious closure not only of post offices whose retail costs exceed revenues, but many other post offices — for example, those whose retail costs exceed 50 percent of revenues. Within the context of the Postal Service being a self-sustaining entity, the continuing decline in revenues from First-Class Mail means that continued subsidization of Periodicals and uneconomic post offices is no longer feasible. The tradeoffs may be unpleasant, but because of cumulative losses, difficult choices must be made.

G. Available Commission Remedies.

The Commission has already invoked its remedial powers in the FY 2010 ACD with respect to Standard Mail Flats. The Postal Service filed a petition for review from the Commission's order, and oral argument in that case before the U.S. Court of Appeals for the D.C. Circuit is scheduled for February 7, 2012. The Commission's ACD must be issued by approximately March 28, 2012, and it is unlikely that it will have the benefit of the court's opinion. Therefore, if the Commission makes a determination of noncompliance, it will need to develop a remedy.

Valpak urges the Commission to find that the two Periodicals products violate the factors and objectives of PAEA, as discussed above, as well as 39 U.S.C. section 101(d). PAEA specifies that if the Commission finds noncompliance with various factors and objectives of PAEA as well as 39 U.S.C. section 101(d), it "**shall** take appropriate action" (section 3653(c), emphasis added) in accordance with section 3662(c), which states that the Commission:

> **shall** order that the Postal Service take such action as the Commission considers appropriate in order [i] to **achieve compliance** with the applicable requirements **and** [ii] to **remedy** the effects of any noncompliance (such as ordering **unlawful rates to be adjusted to lawful levels, …** [or] ordering the Postal Service to discontinue providing loss-making products…). [Emphasis added.]

Reading this language according to its plain meaning, the Commission is mandated to develop a remedy, and that remedy must have two elements: (i) achieve compliance; and (ii) remedy the effects of any noncompliance. The requirement that the Commission forge a remedy to address prior noncompliance would appear to be secondary, to be addressed at a later time.

The first goal is to stop the hemorrhaging and achieve compliance, which requires the Commission to order either: (i) that prices be adjusted above the cap, or (ii) that the two Periodicals products as currently fashioned be discontinued and replaced with a discount.

1. **Pricing Remedy**.

The Commission could use its authority to order "unlawful rates to be adjusted to lawful levels" by ordering specific increases to be made within a specified period of time.[73] Although the Postal Service could be provided some pricing flexibility within the Commission's mandate, there must be some specific targets established by the Commission to have Periodicals achieve cost coverage through both cost cutting and above-cap price increases.

2. **Replacing the Periodicals Class with Establishment of a Periodicals Discount in Other Classes**.

In the Periodicals Mail Study, the Commission and the Postal Service appear to have jointly recommended discontinuing Periodicals as a class, and substituting for it a "bottom line discount to recognize the ECSI value of Periodicals" within the remaining classes. *See* Periodicals Mail Study, pp. 93-94. This is a creative and important suggestion. The Commission could move toward this approach using its powers under section 3662(c), to "order[] the Postal Service to discontinue providing loss-making products."

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[73] Interestingly, the 90-day deadline for the Commission's ACD under 39 U.S.C. section 3653(b) appears only to govern the Commission's determination of compliance or noncompliance — not the issuance of a remedial order under section 3653(c). In other words, if the Commission makes a finding of noncompliance for Periodicals in this ACD, it then could initiate promptly additional proceedings to determine an appropriate remedy consistent with 39 U.S.C. section 3662(c), with input from the Postal Service and concerned parties.

The time to await the results of studies, to allow matters to develop, or to hope for a miracle is now over. Indeed, the Commission may be addressing the Periodicals issue for the last time before Congress imposes its own solution on the Postal Service and the Commission. No one wants to violate the maxim: "Never pick a fight with someone who buys ink by the barrel." However Congress has placed the duty on the Commission, and has provided the Commission with the tools necessary to remedy the problem of Periodicals losses. The path of least resistance had been to transfuse involuntarily the lifeblood from other mailers into Periodicals to keep the class alive. The time has come for the Commission to make a finding of noncompliance under 39 U.S.C. section 3653 and issue a clear remedial order with respect to Periodicals.[74]

VI. THE POSTAL SERVICE MUST RESTRUCTURE ITS BUSINESS MODEL IN A MANNER THAT WILL REDUCE COSTS SUBSTANTIALLY AND ENHANCE EFFICIENCY.

A. As Currently Structured, the Postal Service Cannot Achieve a Financially Self-sustaining Status.

Although the Commission's ACD is generally retrospective in nature, the Postal Service's failure to generate "adequate revenues … to achieve financial stability" (39 U.S.C. § 3622(b)(5)) in FY 2011 should encourage the Commission to use this ACD, and any other opportunity that presents itself, to help facilitate Postal Service cost cutting. This may require

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[74] If the Commission should believe that it is unable to fashion a remedy, it should report to Congress the need to fix the problem itself while legislation is under active consideration.

the Commission to urge Congress to lift the many existing statutory constraints on its cost cutting, particularly with respect to labor costs and the network size.[75]

In March 2010, the Postal Service published *Ensuring a Viable Postal Service for America: An Action Plan for the Future* ("March Action Plan") — an impressive effort to take a long-range view of Postal Service finances — which noted:

> In **2006** Congress passed new legislation that significantly **modified the postal business model.** It provided limited pricing freedom in Competitive Products but offered little flexibility for the remainder of the business. [*Id.*, p. 2 (emphasis added).]

The March Action Plan goes on to explain that, with the permanent decline in the volume of First-Class Mail and the significant expenses and restrictions imposed by Congress, the business model created by PAEA no longer can be sustained. *Id.*, pp. 3-6. Recognizing that times have changed, the March Action Plan proposes a number of major changes designed to improve the Postal Service's broken business model. Among the changes that are absolutely necessary are major cost-cutting efforts. Unfortunately, many of these efforts have not been assisted by, and sometimes have been hindered by, both the Commission and some in Congress.

If the Postal Service is not allowed to manage a quick return to profitability by cutting costs and changing its structure and business model within existing law, a recent GAO study raises the possibility of truly dramatic change:

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[75] Although the ACD is not specifically required to be submitted to the President and Congress, the Commission has authority to report its recommendations to Congress. *See, e.g.*, 39 U.S.C. § 3651, PAEA section 701.

> Restructuring USPS's business model to adapt to decreased mail use could follow one of three primary models: [i] a government-subsidized federal agency, [ii] the current structure with additional flexibility, or [iii] a private-sector business. [*U.S. Postal Service: Mail Trends Highlight Need to Fundamentally Change Business Model,* Highlights of GAO-12-159SP, p. 1, Oct. 14, 2011.[76]]

The GAO's first alternative, returning the Postal Service to be a subsidized federal agency, likely would eliminate the Commission, return all Postal Service employees to civil service status, and internalize the Postal Service's outstanding debt and its obligation to fund the RHBF. The GAO's third alternative likewise would eliminate the Commission and internalize to the federal government the Postal Service's outstanding debt and obligation to fund the RHBF (since private investors would be extremely unlikely to take on obligations for current debt and retiree health care funding).

The GAO's second alternative, which is less dramatic than the other two, would require extensive restructuring of the business model. Along these lines, the Postal Service has begun to undertake a much needed transformation of its business model. Broad, fundamental changes — both proposed and yet to be proposed — will have varying impacts on most, if not all, stakeholders. Restructuring must result in a much leaner structure that will enable the Postal Service to survive as an independent, financially self-sufficient organization — hopefully well into the remainder of this century.

The Postal Service needs to achieve not just financial breakeven, but a far higher level of profitability in order to repay the billions of dollars it has been forced to borrow to fund

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[76] http://www.gao.gov/assets/590/585833.pdf

future costs of retiree health benefits. The projected operating loss of $3.0 billion for FY 2012 indicates that, just to overcome that loss and achieve a modicum of operating profit, the Postal Service will need to aim for **cost reductions** that comfortably **exceed $5-6 billion** annually. One way or another, permanent reductions in fixed costs on this order of magnitude must be achieved within the existing legal framework. With negative net worth, no financial reserves, and no borrowing authority, continued operating losses is unacceptable.

Should further declines in the volume of First-Class Mail occur in subsequent years, as the Postal Service now predicts, then even deeper cost reductions may be necessitated, because at some future time the Postal Service is still likely to have to pay tens of billions of dollars to fund the RHBF. Even if Congress were to eliminate immediately all further payments to the RHBF and approve all of the Postal Service's initiatives announced to date as proposed, they might not be sufficient to achieve $5-6 billion in annual savings and begin to restore the Postal Service to financial health.

B. Cost Reductions Need to Extend Far Beyond Volume Variable Costs.

During the Great Recession, the Postal Service demonstrated that volume variable costs can be controlled and reduced as volume declines. That is not sufficient, however, for the new environment. The Postal Service needs to do far more than simply reduce volume variable costs. Substantial, deep reductions in costs traditionally considered "fixed" or "institutional" also are required.

To illustrate, consistent with general understanding of the appropriate level of volume variable costs, assume variable costs declined by 6 percent for every 10 percent decline in volume. In the face of a large decline in volume, in order to achieve financial breakeven

covering all fixed costs, the Postal Service would need to increase rates higher than the CPI rate cap would permit. The rate cap aside, however, an increase in rates is not the way to stem a permanent volume decline. To the contrary, in such an environment, rate increases on anything other than underwater products can accelerate the decline in profitable volume, be self-defeating, and even turn into a so-called "death spiral." The order of the day needs to be retrenchment and cost reduction that go well beyond volume variable costs. Ideally, the Postal Service should be striving to reduce costs sufficiently to permit small price reductions on those products that are highly profitable and highly elastic, which would make them more attractive to users.[77]

When fundamental changes in the operating plan or the infrastructure occur, many costs otherwise considered fixed become variable. As economists are wont to say, in the long run all costs are variable. This means that fundamental long-run changes to the facilities network, service performance standards, and the like can result in costs previously considered fixed or institutional becoming variable. That turns such costs into candidates to be reduced or, possibly, eliminated altogether. The Postal Service's precarious financial condition indicates that a substantial reduction in fixed costs needs to occur sooner rather than later.

One reason some costs are non-volume variable is that they are mandated by Congress, and Congress will need to grant the Postal Service greater latitude to cut labor and network costs. Like PRA before it, PAEA exhorts Postal Service management to operate the company

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[77] The Postal Service also would do well to consider simplifying the pricing structures for each class of mail, along lines suggested by the Postal Service Office of the Inspector General. *See* Postal Service Pricing Strategy Audit Report, USPS OIG Report No. CI-AR-12-002 (Dec. 9, 2011).

in a business-like manner. Toward that end, PAEA continued grants of managerial discretion to the Postal Service to control certain costs and operate efficiently. *See, e.g.,* 39 U.S.C. §§ 101, 401, 403, 404(a) and (b). Of course, the general grant of managerial authority is limited in various ways by Congress, but the Commission should not seek to impose any additional limitations. Many of the limitations and mandates now in the law were enacted at a time when the postal monopoly could be relied upon to generate significant net income (*i.e.*, monopoly profits) which earlier Congresses used to fund their favorite projects. Those days are over.

C. Recent Postal Service Initiatives Would Help Reduce Some of Its Fixed, Institutional Costs.

In accordance with its March Action Plan, the Postal Service has launched numerous initiatives designed to change its operating plan, reconfigure its network, and reduce institutional costs, as well as volume variable costs, including the following matters that have come before the Commission:

- Adopt 5-day mail delivery by eliminating Saturday delivery (Docket No. N2010-1). (*See* Section VI.D, *infra*)
- Close some (a modest portion) of the existing 32,000 retail facilities (Docket Nos. N2009-1 and N2011-1). (*See* Section VI.E, *infra*)
- Reduce the total number of mail processing facilities through consolidation, coupled with elimination of the universal overnight delivery standard for all local First-Class Mail (Docket No. N2012-1). (Valpak will not comment here on any particulars related to this initiative, as it is currently pending before the Commission.)

Estimates of cost reduction that might be achieved by each of the above initiatives, as those initiatives currently are structured, of course, are subject to uncertainty. However, even if the most optimistic cost reductions are achieved, they will not be sufficient to restore the Postal

Service to profitability. In view of the fact that the Postal Service has been drained of all financial reserves, failure to restore profitability quickly could have serious but unknown consequences, not only for the Postal Service itself, but also for all stakeholders, including employees.

D. The Commission's FY 2011 ACD Should Support the Postal Service's Move toward 5-day Delivery.

On March 30, 2010, the Postal Service filed a request for the Commission to issue an Advisory Opinion under 39 U.S.C. section 3641 to address the Postal Service's proposal to eliminate regular Saturday delivery. In response, the Commission convened Docket No. N2010-1. The Postal Service's request was demonstrably necessary to eliminate the substantial cost of Saturday delivery, which can no longer be justified in view of the decrease in mail volume over the past decade. Continuing volume decreases reported in the 2011 Annual Report (in Form 10-K Report) and projected to continue in the FY 2012 Integrated Financial Plan reduce even further any necessity for Saturday delivery. Valpak participated in Docket No. N2010-1, filing both an Initial Brief[78] and Reply Brief[79] explaining why it believed that the record evidence in the docket overwhelmingly supported the Postal Service's proposal.

The Postal Service estimated that 5-day delivery could save $3.1 billion per year, whereas the Commission's Advisory Opinion estimated that the annual savings, after full implementation, would amount to less, $1.7 billion. The Commission's estimate reflected

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[78] http://prc.gov/Docs/70/70513/VP%20N2010-1%20Initial%20Brief.pdf

[79] http://prc.gov/Docs/70/70607/VP%20N2010-1%20Reply%20Brief.pdf

gross savings of $2.276 billion, less $0.587 of lost revenue.[80] Docket No. N2010-1, Advisory Opinion on Elimination of Saturday Delivery, p. 32.

In order to attain 5-day delivery, it will be necessary for Congress to remove the appropriations rider which for nearly 30 years has required the Postal Service to maintain 6-day city and rural residential delivery service at the 1983 level. *See, e.g.*, Consolidated Appropriations Act, 2012, Pub. L. 112-74, section 532. The irony would not be lost should Congress end up giving the Postal Service a taxpayer bailout because of its insistence on universal 6-day residential delivery. To help avoid such an outcome, Congress needs to make a tough decision to permit Postal Service management to adjust delivery service to match the decreasing volume and increasing number of delivery points.

With respect to moving to 5-day delivery, Commission support would be particularly helpful to the House and Senate Appropriations Committees.[81] Even with support from the Commission, it will be difficult for the Postal Service to implement cost-cutting initiatives and Valpak urges the Commission to use this year's Annual Compliance Determination to help remove, not insert, obstacles in the Postal Service's way as it seeks to regain a measure of

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[80] Interestingly, when estimating the cost of universal service, the Commission used as the FY 2010 cost of 6-day delivery, instead of 5-day delivery, $2.427 billion — an amount higher than its estimate of gross savings in Docket No. N2010-1. Commission Annual Report to the President and Congress, FY 2011, p. 42, Table 5.

[81] President Obama signified support of 5-day delivery in his budget plan, Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction, Sept. 2011, p. 23 http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/jointcommitteereport.pdf.

financial stability.[82] A successful move to 5-day delivery could help forestall other, even more problematic, cost-cutting changes.

Even if the Commission's smaller estimate of savings from 5-day delivery is right on target, the Postal Service still needs to save every dollar it can. Commission support in this year's ACD would provide Congress with helpful guidance so that implementation of the significant cost savings to the Postal Service might begin sometime in FY 2013. Even with Commission support, there is no guarantee that Congress will act prudently, but at least the Commission will have demonstrated that it takes seriously its responsibility under PAEA "[t]o assure **adequate revenues**, including retained earnings, to maintain **financial stability**." 39 U.S.C. § 3622(b)(5) (emphasis added).

E. The Commission's ACD Should Encourage the Postal Service to Seek Major Cost Reductions from Closure of Retail Facilities.

The Postal Service's March Action Plan for achieving savings in its retail network calls for placing far greater reliance on lower cost alternatives, such as contract postal units

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[82] Two years ago, Valpak urged the Commission to "report to Congress about the urgent need of the Postal Service to have the flexibility, as needed, to move to 5-day delivery, to increase its efficiency, reduce its costs, increase revenues, and increase its free cash flow." Docket No. ACR2009, Valpak Initial Comments, p. 39 (Feb. 1, 2010). Thereafter, the Commission testified before the House Committee on Oversight and Government Reform opposing various Postal Service cost cutting proposals, characterizing them generally as proposals to "reduce service." *See* Testimony of Ruth Y. Goldway, Apr. 15, 2010. http://prc.gov/Docs/67/67687/Chairman's%20House%20Testimony%204%2015%2010_836.pdf. In August 2011, the Commission issued its Section 701 Report to Congress which did not support granting the Postal Service any new powers to cut labor and infrastructure costs. *See* Postal Service response to Commission's draft Section 701 Report, pp. 8-15. http://www.prc.gov/Docs/75/75994/701_Report-092211.pdf. Efforts to impede the Postal Service in its cost cutting not only are highly detrimental to Postal Service finances, they also could result in the Postal Service reverting to government agency status.

("CPUs"), Community Post Offices ("CPOs"), and Village Post Offices ("VPOs," a new concept). As the Postal Service from time to time observes, it has more retail outlets than McDonald's, Starbucks, and Walmart combined. At the same time, with the sharp and continuing decline in single-piece First-Class ("Aunt Minnie") Mail, the number of stamps bought and used has diminished, along with the need for retail facilities.

The Postal Service spends a great deal of money maintaining and operating its retail facilities. At the same time, as the Commission noted in its recent Advisory Opinion in Docket No. N2011-1, the Postal Service cannot tell how much it spends on the retail function, *per se*, as opposed to the delivery function, because both delivery and retail often operate out of the same facility, and cost records for such "joint-use" facilities cannot distinguish between the two.

Not knowing the total amount that the Postal Service spends on retail in individual facilities, or on total retail for all facilities combined, it is difficult to estimate the scope of potential savings from serious, meaningful restructuring. This is a major shortcoming in the cost data presented in this year's ACR, and Valpak would urge the Commission to recommend to the Postal Service that, in next year's ACR, it be able to isolate and distinguish retail costs from delivery costs.[83]

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[83] A recent study by the Postal Service OIG suggested that putting delivery operations in facilities separate from retail operations might be advantageous for both functions. Postal Service OIG Report, Retail and Delivery: Decoupling Could Improve Service and Lower Costs (Report No. RARC-WP-11-009), Sept. 22, 2011. Having separate facilities obviously would provide separate and accurate costs for retail. However, separate physical operations should not be necessary in order for the Postal Service to obtain an accurate cost estimate for retail.

Assuming that in its 32,000 retail facilities the Postal Service has between 32,000 and 64,000 full-time equivalent personnel devoted to retail, the costs presumably are large. Potential savings that could be realized from a significant reduction in personnel and real estate costs doubtless add up to hundreds of millions, probably billions, of dollars. In Docket No. N2011-1, the Postal Service selected for study 3,650 facilities, which included many of the smallest facilities in the entire retail network. It was thought that closure of all of the smaller facilities included in the study would save about $200 million, which averages less than $60,000 per facility. Nothing is wrong with trying to save $200 million, but it does not get the Postal Service anywhere close to where it needs to be. The Commission should consider getting one step ahead of the Postal Service by recommending that it achieve much greater savings in its retail operations. To achieve the kind of cost reductions in retail that are needed, the Commission should advise the Postal Service to follow Sutton's Law[84] — *i.e.*, focus on closing many of its larger retail facilities, most especially those with high costs, and transfer them to private sector operation, along lines described in the March Action Plan.

As the Commission also observed in its Advisory Opinion in Docket No. 2011-1, the Postal Service needs to open alternative outlets such as CPUs, CPOs, and VPOs **before** it closes retail facilities that they intend to replace. This recommendation by the Commission makes eminent good sense. With respect to such alternative outlets, though, the Postal Service unfortunately seems to be regressing. For instance, in FY 2005, the Postal Service had 3,118 CPUs and 1,019 CPOs. FY 2009 Form 10-K Report, p. 70. Six years later, in FY 2011, the

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[84] This "law," which says that one should go "where the money is," derives from Willie Sutton, a well-known student of banking practices.

Postal Service had only 2,904 CPUs and 706 CPOs, reflecting declines of 214 and 313, respectively. FY 2010 ACD, Table VI-11, p. 72, and FY 2011 Form 10-K Report, p. 88. On a net basis, the Postal Service has been closing alternate retail facilities when instead it should be opening far more of them. *See* Postal Service Response to ChIR No. 1, question 41.

F. The Postal Service Needs to Evaluate Moving from Door Delivery to Curbside Delivery.

On July 7, 2011, the Postal Service Office of the Inspector General issued an audit report, Modes of Delivery (Report Number DR-AR-11-006).[85] That report found that if the Postal Service converted a large portion of door delivery addresses to less expensive curbside delivery, it could save $4.5 billion per year. Nonetheless, the Postal Service has been extremely reluctant to consider such an approach. In its March Action Plan, it reported that "[t]his option will not be pursued at this time." Yet, if the Postal Service is impeded in its other cost savings measures, it will be forced to revisit this approach, which can be done without Commission or Congressional authorization.

VII. STANDARD MAIL COST ISSUES REMAIN TO BE ADDRESSED.

Accurate costing is the foundation for rational economic decisions, including pricing, investments, facility consolidation, and others. Valpak therefore strongly supports the Commission's continued efforts to press the Postal Service to improve its costing system. This ACR demonstrates that costing problems remain in the area of Standard Mail.

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[85] http://www.uspsoig.gov/foia_files/DR-AR-11-006.pdf

A. Some Improvements Have Been Made in Standard Mail Costing.

In this year's ACR, the Postal Service reviews changes in analytic principles that affected its costing system during FY 2011. Of 20 proposed changes, five proposals (numbered five, six, twelve, sixteen and eighteen) affect costing for Standard Mail. FY 2011 ACR, pp. 5-6. One proposal, number twelve, responded to the Commission's directive in the FY 2010 ACD to disaggregate the cost estimates for nonautomation machinable MAADC and AADC presort Standard Mail letters.

The four other proposed changes concerned (i) establishing certain cost pools in non-MODS ("Management Operating Data System") facilities that parallel cost pools already established in MODS facilities (proposal number six), and (ii) establishing new cost models, methodology and cost pools for the Flats Sequencing System, some of which were deployed in FY 2010, but were not operational until FY 2011 (proposals five, sixteen and eighteen). As a large portion of flats (First-Class, Standard, Carrier Route, and Periodicals) now are being processed on the FSS machines, in hopes that the FSS will reduce significantly the cost of processing flats, the Postal Service clearly needs to have separate, reliable cost data for this new sorting equipment.

B. Cost Differences Between Saturation and High Density Letters Persist, and Need Some Explanation.

Table VII-1 shows the unit mail processing cost for Standard Mail High Density and Saturation Letters for the years FY 2008 through FY 2011. Comparison of the two rows in Table VII-1 shows that the unit mail processing cost has been persistently lower for High Density letters than for Saturation letters, with the most recent FY 2011 result being no

exception. The only year when the mail processing cost difference was sufficiently negligible for the anomaly to be ignored was FY 2009.

Table VII-1
Standard ECR Letters — Mail Processing Unit Costs
(With dropship adjustment)
(Cents per piece)

	FY11	FY10	FY09	FY08
Saturation letters	1.9766	2.1928	2.0934	1.8443
High Density letters	1.7586	2.0816	2.0857	1.4162

Sources: USPS-FY11-18, USPS-FY10-18, USPS-FY09-18, and USPS-FY08-18.

The majority of both Saturation and High Density letters now are delivery point sequenced (“DPS’d”), and for those letters one would expect the mailing processing unit cost to be quite similar, if not identical. For the portion of High Density letters not DPS’d, the remainder must be cased by carriers. For Saturation letters not DPS’d, some would be cased while others may be taken directly to the street as a third bundle. Saturation letters can be cased faster than High Density letters, hence casing of Saturation letters is less costly, and the option of taking Saturation letters directly to the street as a third bundle involves virtually no in-office mail processing cost at all. Thus, *a priori*, it would be reasonable to expect that Saturation letters, because of their higher density, would have a lower unit mail processing cost, and certainly would not have a higher average unit mail processing cost. On this basis, the data in Table VII-1 appear to be anomalous.

Table VII-2 shows the unit delivery cost for Standard Mail Saturation and High Density letters for the years FY 2008 through FY 2011. Comparison of the two rows in Table 2 again

shows that the unit delivery cost is persistently lower for High Density letters than it is for Saturation letters. Although the cost difference is larger in some years than others, for the last four years the unit delivery cost for High Density letters has been persistently lower.[86]

Table VII-2
Standard ECR Letters Delivery Unit Costs
(Cents per piece)

	FY11	FY10	FY09	FY08
Saturation letters	4.488	4.272	4.065	3.943
High Density letters	3.655	3.658	3.892	3.620

Sources: USPS-FY11-19, USPS-FY10-19, USPS-FY09-19, and USPS-FY08-19.

When carriers are delivering mail on their routes, all letters to the same address are delivered together. Why the Postal Service reports a higher cost to deliver Saturation letters is not clear. On any particular day, some addresses may receive:

(1) neither a Saturation letter nor a High Density letter, in which case the unit cost would be identical — *i.e.,* zero;

(2) both Saturation and High Density letters, in which case both would incur a cost, and *a priori* the unit cost for letters delivered together should be identical; or

(3) some of one and none of the other, in which case the cost of delivering a Saturation letter presumably — but for reasons unexplained and possibly unknown — has a higher cost than a High Density letter (otherwise, Saturation letters would not have a higher average unit cost).

[86] At the Commission's technical conference for Docket No. RM2011-3 on January 12, 2012, some of the difficulties involved in estimating the attributable delivery cost for each product were discussed, but not resolved.

Table VII-3 combines the unit costs shown in Table VII-1 and VII-2. The bottom line shows this combined cost for Saturation letters as a percent of the combined cost for High Density letters.

Table VII-3
Standard ECR Letters Mail Processing and Delivery Unit Costs
(Cents per piece)

	FY11	FY10	FY09	FY08
Saturation letters	6.4646	6.4648	6.1584	5.7873
High Density letters	5.4136	5.7396	5.9777	5.0362
Saturation as a percent of High Density	119.4%	112.6%	103.0%	114.9%

Sources: Tables 1 and 2.

A driving force underlying the Postal Service's current drive to consolidate mail processing facilities is that higher density is presumed to result in lower unit costs. If the summary data in Table VII-3 are correct, they indicate that less density is less costly. The matter requires additional study.

In an effort to develop some insight on the reported FY 2011 difference in mail processing costs shown in Table VII-1, Valpak examined the costs attributed by individual cost pools. Selected data are shown in Table VII-4.

Table VII-4
Volume and Selected Cost Pool Data for
Saturation and High Density Mail
FY 2011

	Saturation Letters	High-Density Letters	Ratio Sat/H-D
Volume (000)	3,139,161	2,514,714	1.248
Unit costs (cents)	1.7754	1.6174	1.098
Cost Pools – MODS Groups			
AFSM100	464	265	1.751
FSS	689	302	2.281
1DSPATCH	1,298	295	4.400
1PRESORT	718	87	8.253
1SCAN	384	106	3.623
1MISC	336	114	2.947
1SUPPORT	659	112	5.884
LD43	1,855	785	2.363
LD44	360	115	3.130
LD79	2,536	0	n/a
Cost Pools – Non-MODS Groups			
ALLIED	1,855	264	7.027
AUTO/MEC	1,108	147	7.537
N_BulkAccp	568	0	n/a
N_PO Box	346	0	n/a
N_MANF	356	0	n/a

Source: USPS-FY11-18, Workbooks, File FY11 ECR Unit Costs, Tab Summary Data.

Shown in the top row of Table VII-4 are the combined volumes, over 4.6 billion pieces, which should be sufficiently large so as not to involve any small sample problem. The ratio of Saturation volume to High Density volume is computed as a sort of benchmark for the discussion that follows.

To begin, a few comments about the first two cost pools in Table VII-4. Both are flats cost pools. The actual number of IOCS ("In-Office Cost System") tallies is not known, but the costs are a proxy. With respect to the AFSM100 tallies, it seems fair to presume that neither

Saturation nor High Density letters actually were being processed on a flat sorter.[87] A typical explanation for AFSM cost pool tallies as part of letter costs is that the employees were clocked in to the AFSM pool, were detailed elsewhere in the facility, failed to clock out of the AFSM100 cost pool and into wherever cost pool at which the employees actually were working at the time of the tally, and actually were handling Saturation or High Density letters — hence the tallies. Whether the employees were working on a DPS machine or doing something else is not known.

In Table VII-4, the combined cost of the FSS tallies (991) for Saturation and High Density letters exceeds the combined cost of the AFSM100 tallies (729). These FSS tallies are somewhat more troubling, because FSS machines generally are located in facilities dedicated to processing flats and somewhat removed from areas where letters are processed. For employees to be clocked into FSS but in fact working on either Saturation or High Density letters when tallied would indicate that they have relocated from the FSS facility perhaps to an altogether different facility where letters are handled. These tallies thus appear sufficiently anomalous to deserve some further investigation and explanation by the Postal Service.

With respect to cost pools such as dispatch, acceptance, and allied labor, these activities are common to both Saturation and High Density letters. The fact that the ratio of these activities common to both is so disproportionate to the ratio of the volumes raises an issue of whether the sample suffers from being too small, or whether some subtle implicit bias exists

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[87] Letter-shaped digest-size pieces that do not process well on letter sorting equipment may be processed on a flat sorter, thus giving rise to tallies of letters on flat sorting equipment. However, rarely if ever are Saturation letters digest size.

and results in IOCS tallies of Saturation letters being disproportionately large relative to High Density letters.

C. Carrier Route Letters Demonstrate Another Standard Mail Costing Issue.

A separate recurring costing problem is another unexplained surge in the delivery cost of Carrier Route letters, this time from 17.758 cents last year to 33.426 cents this year. *See* USPS-FY-10-19, File UDCmodel10, Tab Table 1, Cell column 3, row 74, and USPS- FY-11-19. The unit cost of delivering a Carrier Route letter is **up an additional 88 percent** from last year, with no explanation provided. The result appears to be too anomalous to support pricing decisions. Carrier Route letters are presorted to line of travel. The unit cost of delivering Carrier Route **letters** in FY 2011 reportedly was three times the cost to deliver Carrier Route **flats** (11.061 cents in column 7, row 74), and nine times the cost of delivering High Density letters (3.655 cents in column 3, row 75).

Within Carrier Route mail, letters constitute only 2 percent or so of total volume, and this relatively small size may create a sampling problem. The Commission should ask the Postal Service to explain in the ACR any unit cost that, on a year-to-year basis, fluctuates substantially, *e.g.*, more than, say, 50 percent from the prior year. The explanation should include confidence intervals for each year, and the likelihood that the year-to-year change represents a correct measure of the change in cost. Problems arising from small sample size need to be highlighted because they are pertinent to any proposal to decrease the size of IOCS sampling frames.

A different approach to development of cost estimates may be needed in those instances where sample sizes are too small to be reliable or produce credible results. Valpak suggests

that the Commission and the Postal Service investigate possibilities such as the following: (i) using an estimate based on modeled costs in lieu of that based on the work sampling system, or (ii) for troublesome small-sample estimates, averaging costs over more than one year accompanied by whatever adjustments are deemed appropriate (*e.g.*, an adjustment for inflation in postal costs).

D. The Postal Service Continued to Lose Significant Sums on DALs during FY 2011 Which Should Be Mitigated by the Recent Price Increase.

The volume of Detached Address Labels ("DALs") continues to decline. FY 2011 billing determinants (USPS-FY11-4) recorded 710 million DALs, which is 7 percent less below the 762 million DALs recorded in the FY 2010 billing determinants, and 21 percent below the 902 million DALs recorded in the FY 2009 billing determinants. This year, city and rural carrier cost systems counted 582 million Saturation DALs, plus another 21 million High Density DALs and 18 million Carrier Route DALs, for a total of 621 million.[88] Although those counts do not reconcile 100 percent with the billing determinants, they reflect a considerable improvement over prior years when the difference from billing determinants was substantially larger.

The surcharge for using optional DALs remained unchanged throughout FY 2011 at 1.7 cents, and resulted in revenue of $12.04 million in FY 2011. As Valpak indicated in its comments last year, revenue from the surcharge applicable to DALs is estimated to have covered somewhat less than one-half of their actual delivery cost — *i.e.*, DALs had an attributable mail processing and delivery cost (including piggybacks) somewhere in the

[88] USPS-FY11-19, UDCInputs11, Tabs CCSDALs and RCSDALs.

neighborhood of $30-32 million, which was more than twice the revenue, with implied cost coverage probably somewhat less than 50 percent.[89]

In its most recent price adjustment filed in Docket No. R2012-3, the Postal Service now appears to concur generally with Valpak's prior observation. The Postal Service's initial price adjustment for DALs was 5.0 cents, subsequently amended to 3.0 cents.[90] In justification for this price increase, the filing stated that:

> The Postal Service believes that **the surcharge does not fully cover the additional costs of DALs** when used with flats, and that DALs are not needed for Saturation flats. The Postal Service observes that some mailers still use DALs with their Saturation flats, but believes that saturation flats with on-piece addressing are **less costly to process and deliver than flats with DALs.** [*Id.*, p. 22 (emphasis added).]

The initially-proposed price adjustment of 5.0 cents likely would have increased cost coverage of DALs to 100 percent, perhaps more. The revised lower price of 3.0 cents nevertheless should increase coverage significantly. It also may result in a further diminution in the volume of DALs. In general, whenever the volume of a money-losing product declines, the Postal Service's bottom line can be expected to improve because costs should decline more than revenues. In this particular instance, fewer DALs will enhance Postal Service profitability, provided those pieces continue to be mailed, either with on-piece addresses or using the simplified addressing option. Either of these two options, incidentally, should not

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[89] *See* Docket No. ACR 2010, Initial Comments of Valpak, p. 64 (filed Feb. 2, 2011). For DALs, the total cost, including piggybacks, is not readily available.

[90] Docket No. R2012-3, USPS Notice of Revised Price Adjustment for Detached Address Labels (Nov. 15, 2011).

seriously disadvantage any mailer because they would reduce postage costs for those mailers that still used DALs in FY 2011. Saturation host pieces are quite profitable for the Postal Service, but whenever mailers elect to use optional DALs, they diminish that profitability. The Postal Service clearly seems to be moving in the right direction with respect to DALs.

E. Retail Operations Pose a Major Costing Issue.

The Postal Service has substantial detailed data on the attributable cost of its various and sundry Auxiliary and Special Services. The FY 2011 CRA, for example, indicates that the attributable cost for Domestic **Ancillary Services** was $1,377.1 million, all **Special Services** had an attributable cost of $761.7 million, and, for all Market Dominant Special Services, the total attributable cost was $2,137.6 million. Rural carriers can function as "post offices on wheels," and those carriers are known to provide customers with some Ancillary and Special Services from time to time. The vast majority of attributable costs of Market Dominant Special Services doubtless arise, however, from transactions at retail counters. In Docket No. RM2012-1, which is currently before the Commission, proposals fourteen and fifteen provide insight on the level of detail that underlies the estimation of attributable cost for individual special services.

It is interesting to observe the rather stark contrast between (i) the extant detailed knowledge about those retail activities in the categories of Ancillary or Special Services, and (ii) what the Postal Service does not know concerning the cost of its other retail activities not classified as a special service.[91] With respect to any individual retail facility, in the absence of

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[91] *See* the discussion in Section VI.E, *supra*.

a special study, which usually occurs only in the event the Postal Service decides to consider the possibility of closure and consolidation, the Postal Service does not know the total cost of retail operations at that facility. This is especially the case when the facility also houses carrier operations. It stands to reason that if the Postal Service does not have a reliable estimate of the cost of retail operations at any individual facility, it does not have a reliable estimate of the aggregate cost of all of its far-flung retail operations.

In addition to the $2,137.6 million of attributable cost regarding Market Dominant Special Services, the attributable cost of all other revenue-producing retail transactions (primarily sale of stamps) could amount to anywhere from $2–4 billion. This would seem to be a rather substantial omission in the Postal Service costing system. Valpak would suggest that in addition to (1) Ancillary Services and (2) Special Services, the Commission consider expanding the CRA to include a third section, such as "All Other Revenue-Producing Window Services." Stamp sales, which are said to constitute 85 percent of all window transactions, obviously would be the largest candidate for any such new category.[92] This would provide the Postal Service and the Commission with a good estimate of the total attributable cost of retail window services.[93]

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[92] To avoid double-counting, revenues obviously would need to be recorded as a non-add item, since all revenue is allocated to the various classes of mail.

[93] The total cost of retail window services would include non-attributable costs, such as idle time of clerks when there are no customers to be served.

VIII. SERVICE PERFORMANCE MEASUREMENT FOR STANDARD MAIL IS UNDERWAY.

A. FY 2011 Begins the Reporting of Standard Mail Performance Measurement Data.

FY 2011 marks the dawn of a new era with respect to performance measurement of Standard Mail — the last major class of mail without performance measurement data.[94] Many mailers who rely on Standard Mail long have desired to see the Postal Service institute a performance measurement system and provide some accountability for service. (In FY 2010, the Postal Service determined that the Standard Mail performance data collected that year suffered from quality flaws too severe to support any analysis or conclusions, and all collection of performance data for Standard Mail then stopped until Q3 of FY 2011.)

Now, five years after PAEA was enacted, the Postal Service has produced a small amount of usable, reliable data on actual performance for Standard Mail, although complete performance data will not be available for another year. No data were collected during Q1 and Q2 of FY 2011; in Q3 the only data collected were for destination entry Standard Mail; in Q4 the data for end-to-end Standard Mail were extremely sparse (*see* Section VIII.F, *infra*).[95]

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[94] For many years performance of stamped First-Class Single-Piece letters has been measured by the EXFC system, which is being expanded so as to be more comprehensive, both geographically and with respect to other First-Class Mail products. Priority Mail was separately monitored for a time. Periodical mailers likewise for many years have had Red Tag and Del-Trak, the two systems now adopted, at least on an interim basis, as the recognized performance measurement system for Periodicals. And, ever since the Postal Service implemented Delivery Confirmation, it has been able to track delivery performance for some parcels.

[95] "In Quarter 1 and Quarter 2, no Standard Mail results were available because no mailers were certified. In Quarter 3, mailers were certified only for Destination Entry mail." USPS-FY11-29, p. 13.

Nevertheless, performance measurement for Standard Mail finally is at least out of the starting gate. Hopefully, publication of these data will result in both (i) meaningful service improvements, and (ii) increased accountability.[96]

Four of the six Standard Mail products have significant cost coverage and make a significant contribution ($6.51 billion) to the Postal Service's institutional costs. (Unfortunately, losses from Standard Mail Flats and Standard Parcels & NFMs reduce the total contribution from the class to $5.75 billion.)[97] The contribution from profitable Standard Mail products is growing, and will be relied upon increasingly with further declines in First-Class Mail volume projected by the Postal Service. It would seem to be in the Postal Service's own best interest to use this newly-installed performance measurement system to improve the quality of service provided to Standard Mail.

B. The Postal Service's Performance Report Contains Multi-year Performance Data for First-Class Mail.

39 U.S.C. section 2803(a) requires the Postal Service to prepare an annual performance plan, which can be found in the Postal Service's *2011 Annual Performance Report and 2012 Annual Performance Plan* published with the *2011 Comprehensive Statement on Postal*

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[96] "As robust Intelligent Mail data develop, those data provide **diagnostic information to help identify specific areas for improvement.** In addition, Network Distribution Centers ("NDCs") continue to remove unnecessary processes and improve performance." Service Performance of Market Dominant Products, USPS-FY11-29, p. 16 (emphasis added).

[97] *See* FY 2010 ACR, p. 20. http://www.prc.gov/Docs/79/79166/FY.2011.ACR.pdf. Standard Flats continue to lose enormous amounts of money. *See* Section IV, *supra*. Most Standard Parcels and NFMs, also a money-losing product, now have been removed from Standard Mail and transferred to competitive products.

Operations. USPS-FY11-17 ("Performance Report"). The Performance Report "may not omit … **any program activity that is a major function or operation**." FY 2010 ACD, p. 42 (emphasis added.) That report shows comparable summary data for two prior years on **speed** and **reliability** of delivery of First-Class Single-Piece Mail vis-a-vis its established standard. The presentation provides a baseline of **trends for the last two years** to help evaluate performance at a glance regarding both speed and reliability of delivery for First-Class Single-Piece Mail.

Despite the fact that Standard Mail volume (84.7 billion) exceeded First-Class Mail volume (73.8 billion) in FY 2011, and Standard Mail's contribution to institutional cost (over $6.2 billion) was the second largest, the Performance Report does not mention Standard Mail. Hopefully that will change and Standard Mail soon will be recognized as a "program activity that is a major function or operation" (*id.*), because greater visibility will help focus more attention on the performance of Standard Mail.

C. The Performance Report Provides Speed of Delivery Data for All Products, but for FY 2011 Only.

Summary annual data for **speed** of delivery for individual competitive products within each class of mail, including Standard Mail, can be found in a library reference: *Annual Report of Service Performance for Market Dominant Product* ("Performance Library Reference"). USPS-FT11-29. For each product or reporting category (*see* Section VIII.D, *infra*), this library reference commendably gives the current target for on-time delivery, the actual percent delivered on-time, and "volume." All data in USPS-FY11-29 are **for FY 2011 only**. Unlike the Performance Report, the reporting format established for the Performance

Library Reference provides neither comparable data on **speed** of delivery **in prior years**, nor data pertaining to **reliability** of mail delivery for any product, either for the current year under review, or for prior years. Data presented in USPS-FY11-29 thus support no evaluation of year-to-year change or trends in performance, either good or bad. In order to investigate whether performance in the current year has improved or deteriorated, and make requisite comparisons, reference to pertinent documents submitted in prior years would be required.[98] In future years, as performance data for Standard Mail accumulate, the Commission may wish to consider expanding the reporting format for the ACR to include data from at least one prior year. Prior years' data add perspective. Just as it is customary to present summary financial and volume data for multiple years, it also may be worthwhile to present summary national performance data for multiple years.

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[98] After all, the FY 2010 ACD noted: "[t]he review [of quality of service] is undertaken to ensure that quality of service does not deteriorate under the CPI price cap system because of the potential to cut costs by way of service reductions to comply with price cap requirements." FY 2010 ACD, p. 57. Any attempt to ascertain whether quality of service has deteriorated necessarily requires a comparison with prior years.

D. The Quarterly Performance Data Report Contains Detailed Data on Speed and Reliability, but for FY 2011 Only.

PAEA requires that, for all market dominant products, the Postal Service monitor, and the Commission provide, a report to Congress on, the **speed** and **reliability** of mail delivery.[99] These two performance standards are separate and distinct.

- Data showing the percent of mail that achieved **on-time delivery** vis-a-vis established service standards is the statistic which serves as a measure of, or proxy for, **speed** of delivery.

- Data pertaining to when mail not delivered on time actually was delivered serve as a measure of, or proxy for, **reliability**.[100]

On November 10, 2011, the Postal Service filed with the Commission "U.S. Postal Service FY 2011 Q4 Service Performance Reports," which relate to all market dominant classes and products, including Standard Mail.[101] Although not formally incorporated in the Postal Service's ACR, or even referenced in the brief discussion of performance at pages 9-10 of this year's ACR, the detailed on-time data in this quarterly report provide underlying support for the summary **speed** of delivery data reported in the Performance Library

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[99] PAEA requires that the Annual Compliance Report "shall, for each market-dominant product provided in such year, provide — … (B) measures of the quality of service afforded by the Postal Service in connection with such product, including — (i) the level of service (described in terms of speed of delivery and reliability) provided…." 39 U.S.C. § 3652(a)(2)(B).

[100] Stated alternately, mail delivery can be viewed as most reliable when it is least unreliable, and vice versa. To illustrate, if all mail were delivered on time, and there were no tail-of-the-mail, under that (hypothetical) circumstance, delivery would be considered extremely reliable. Conversely, a very large and strung out tail-of-the-mail indicates unreliable delivery.

[101] http://www.prc.gov/Docs/77/77673/Letter_USPS_FY2011_Q4_SPR.pdf and http://www.prc.gov/Docs/77/77673/USPS_FY2011_Q4_SPR.zip.

Reference. For Standard Mail, quarterly performance data are contained in 14 separate files, each consisting of multiple spreadsheets.

Variance data, which show the percentage of mail within each reporting category that was delivered within one, two, or three days beyond the established delivery standard, also are reported. These variance data indicate **reliability** of delivery.

For such national level data as are available this year, Tables VIII-1 and VIII-2 below summarize **speed** and **reliability** of Standard Mail products and reporting categories. Table VIII-1 contains percentages that show **speed** of delivery (*i.e.*, on-time performance) and **reliability** (*i.e.*, variance). Table VIII-2 contains data on the **volume** of Standard Mail monitored.

Although Standard Mail consists of six discrete products, Tables VIII-1 and VIII-2 show data for two "non-product" categories: (1) **mixed** letters, and (2) **mixed** flats/parcels.[102] Postal Service text accompanying the spreadsheets for Standard Mail explains the presence of these two reporting categories as follows:

> The reporting of Standard Mail® product was based on information supplied by the mailers in the electronic documentation. In some cases, the mailers were not required to provide the detailed data that would enable service performance reporting at the product level. In such cases, mail could not be placed into one of the six specific product categories and was instead reported in a category of either Mixed Product Standard Letters or Mixed Product Standard Flats. [FY 2011 Q4 Service Performance Reports.]

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[102] No data are available for the Not Flat Machinables ("NFMs")/Parcels product. In terms of the totality of Standard Mail, this omission is comparatively minor. "Parcels represented less than one percent of Standard Mail in FY 2011." USPS-FY11-29, p. 15. The discussion of performance indicates that the Postal Service has plans to rectify this omission.

The mixed categories constituted a significant portion of the total Standard Mail volume reported in FY 2011. "In Quarter 4, 61 percent of measurable Standard letters and 91 percent of flats fell into [these two mixed categories.]" USPS-FY11-29, p. 14. The necessity to report mail in these two mixed categories, coupled with the large percentage so reported, means that neither mailers nor the Commission have performance data for individual products within Standard Mail. The Postal Service obviously needs to improve its reporting system so as to be able to correlate monitored pieces with individual products.

Table VIII-1
Performance Data For Standard Mail
Fiscal Year 2011

A. Destination Entry

	Percent Two-Day				Percent Three-to-Four Days				Percent Five-to-Ten Days			
	On Time	--Days Late-- 1	2	3	On Time	--Days Late-- 1	2	3	On Time	--Days Late-- 1	2	3
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
LETTERS												
1. Standard	n/a	n/a	n/a	n/a	78.1	94.0	97.7	98.9	75.2	91.1	95.7	97.6
2. Mixed	n/a	n/a	n/a	n/a	69.6	88.5	95.5	97.9	75.4	89.2	94.6	96.9
3. H-D & Sat.	n/a	n/a	n/a	n/a	87.0	96.0	98.3	99.1	83.3	93.9	97.9	98.9
FLATS												
4. Standard	n/a	n/a	n/a	n/a	59.3	78.5	88.0	92.9	60.8	77.5	86.4	91.4
5. Carrier Rte	n/a	n/a	n/a	n/a	48.5	69.7	81.9	89.1	64.9	78.3	87.5	92.5
6. Mixed Flts/Pcls	n/a	n/a	n/a	n/a	58.3	78.1	88.2	93.3	69.8	83.8	90.9	94.6
7. H-D & Sat.	95.0	98.5	99.6	100.0	54.4	64.4	74.3	82.9	43.5	84.0	91.7	95.6

B. End-to-End

	Percent Three-to-Five Days				Percent Six-to-Ten Days				Percent Eleven-to-Twenty Two Days			
	On Time	--Days Late-- 1	2	3	On Time	--Days Late-- 1	2	3	On Time	--Days Late-- 1	2	3
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
LETTERS												
1. Standard	61.9	77.8	86.4	91.2	39.8	56.6	70.5	80.7	14.8	24.8	35.6	46.9
2. Mixed	63.5	77.3	86.2	90.9	38.6	54.7	68.7	78.9	18.6	32.2	42.0	55.9
3. H-D & Sat.	60.9	85.3	99.4	99.7	8.3	42.7	67.1	81.9	n/a	n/a	n/a	n/a
FLATS												
4. Standard	41.4	61.5	75.6	84.5	62.1	72.9	81.4	88.2	44.9	52.0	54.3	71.2
5. Carrier Rte	56.3	77.9	84.1	85.1	30.1	50.1	61.5	76.1	33.1	50.8	57.0	72.0
6. Mixed Flts/Pcls	35.6	5.2	62.7	72.9	28.3	43.0	57.0	68.1	16.2	28.5	40.6	52.3
7. H-D & Sat.	82.9	94.8	97.4	99.3	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Source: USPS FY 2011 Q4 Service Performance Report, Standard Mail.
Spreadsheets for each respective product and delivery standard shown.

Table VIII-2
Volume of Standard Mail Recorded by Postal Service Monitoring System
Fiscal Year 2011
(000)

A. Destination Entry

	Two-Day	Three-to-Four Days	Five-to-Ten Days
LETTERS			
1. Standard Mail	N/A	1,203,551	216,788
2. Mixed	N/A	2,269,322	479,360
3. H-D & Saturation	N/A	82,191	1,936
FLATS			
4. Standard	N/A	55,738	24,674
5. Carrier Route	N/A	74,568	5,106
6. Mixed Flats/Parcels	N/A	1,039,448	207,645
7. H-D & Sat. Flats/Parcels	2,991,719	1,165	21
Totals	2,991,719	4,725,982	936,530

B. End-to-End

	Three-to-Five Days	Six-to-Ten Days	Eleven-to-Twenty Two Days
LETTERS			
1. Standard Mail	3,205	33,222	6,152
2. Mixed	12,098	87,990	2,376
3. H-D & Saturation	128	89	N/A
FLATS			
4. Standard	37	721	42
5. Carrier Route	19	15	
6. Mixed Flats/Parcels	899	12,686	552
7. H-D & Sat. Flats/Parcels	58	N/A	N/A
Totals	16,443	134,724	9,122

Source: USPS FY 2011 Q4 Service Performance Report, Standard Mail, Spreadsheets for each respective product and delivery standard shown.

E. Review of FY 2011 Standard Mail Speed and Reliability Data.

Performance data indicating **speed of delivery** (*i.e.*, percent delivered on time) is shown in Table VIII-1. "The Postal Service set aggressive on-time targets of 90 percent or above for all market dominant products." FY 2011 ACR, p. 10. Although most reporting categories shown in Table VIII-1 failed to meet this on-time target, there has been no indication that the Postal Service's proposals in Docket No. N2012-1 will change service standards for Standard Mail for the continental United States. For end-to-end Standard Mail, performance data shown in Table VIII-1 indicate that (i) any mailer expectation of on-time delivery should be significantly less than it is for mail entered at destinating facilities, and (ii) the farther the distance traveled through the postal network and the more days allowed by the delivery standard, the lower the probability that the mail will be delivered on time.

The greater problem is **reliability of delivery**. The Postal Service to this day has not established any standards or targets for reliability. In other words, the Postal Service has not established any standard for the cumulative percent of mail that it expects to be delivered within 1, 2, or 3 days of the established delivery standard. It would be helpful for the Postal Service to establish a target for the cumulative percent of mail expected to be delivered within 3 days of the established delivery standard. The variance data in Table VIII-1 indicate that service received was generally unpredictable and unreliable for any end-to-end Standard Mail product required to travel very far through the postal network.

F. Review of FY 2011 Standard Mail Volume Data.

Volume data (Table VIII-2) indicate breadth of the sample. The volume of **destination-entered** mail included in this year's report (8,653 million) represents a good start, but the volume of **end-to-end** data (160 million) was sparse — under 2 percent of all monitored pieces.

In Q3, the total reported "volume" of monitored mail was 2,499 million, and in Q4 the total "volume" exceeded 6,314 million. Q4 thus witnessed a substantial increase in the pace at which performance of Standard Mail was being monitored. However, the Postal Service also explains that:

> The volume of a district, an area or the nation includes the mail pieces originating from and/or destinating to the district/area/ nation. Because the results shown are origin/destination combined results, **each piece is counted twice** – once according to its origin and once according to its destination. As a result, **the national volumes shown are two times the actual measured pieces.** [USPS FY 2011 Q4 Service Performance Report (emphasis added).]

Total volume of Standard Mail exceeded 84 billion pieces in FY 2011. FY 2011 ACR, Table 2, p. 20. The 4.4 billion pieces recorded in the performance measurement database thus represent only 5 percent of all Standard Mail. The data in Table VIII-1 were preponderantly (97 percent) for Destination Entry Standard Mail, as shown in Part A. USPS-FY11-29, p. 13. Except for the two High Density/Saturation products, this high percentage is disproportionate to billing determinants for FY 2011. In Q4, 85 percent of overall Standard Mail was Destination entry, and 15 percent was end-to-end. USPS FY11-29, p. 13. Thus, end-to-end mail was significantly under-represented.

The next step is to induce mailer participation sufficient to produce results that are statistically reliable for all Standard Mail products, both regionally as well as nationally. Performance measurement begins with the **Intelligent Mail barcode** ("IMb"). To increase size of the sample and representativeness, the Postal Service needs to redouble its efforts to encourage all mailers, especially those smaller mailers who enter end-to-end mailings, to participate in its full-service IMb program. **Expanding the rate differential** to favor those mailers who use the IMb on their Standard Mail is an option that the Postal Service seriously should consider. Traditionally, bulk mailers have been highly responsive to rate inducements, because most are desirous of saving on postage any way they can. Also, a further small rate differential could be used to encourage mailer adoption of the Full Service option. Greater mailer participation in the service performance measurement program will help the Commission carry out its mandate to monitor and report on speed and reliability of service received by all Standard Mail products, as well as increase the value to all mailers.

Standard Mail sits at the bottom of the hierarchy for service. Express Mail, Priority Mail, and First-Class Mail always will take precedence in processing and transportation, as they should. Then, Periodicals mail, despite the fact that it is a perennial money-losing product, will have tighter delivery standards and receive preference over Standard Mail in processing, dispatch and transportation. In its drive to reduce operating costs, if the Postal Service succeeds in eliminating much (or all) of its excess capacity, Standard Mail most likely will be the first to suffer, and its service performance would seem likely to deteriorate, perhaps substantially. In this regard, Standard Mail can be likened to the proverbial "canary in the

coal mine." The Commission therefore will need to monitor performance of Standard Mail closely.

IX. CHALLENGES THAT MUST BE MET BY THE TIMING OF ANNUAL COMPLIANCE REVIEW AND PRICING CHANGES.

PAEA requires that the Postal Service's **annual compliance report** be filed within 90 days after the end of the fiscal year, *i.e.*, by the end of December of each year. PAEA also restricts the time frame for the Commission's review to 90 days, *i.e.*, by the end of March of the following year. *See* 39 U.S.C. §§ 3652 and 3653.

Commission Rule 39 C.F.R. § 3010.7 requires the Postal Service to file and maintain with the Commission a **schedule for regular and predictable price changes** designed to "provide mailers with estimated implementation dates for future Type 1-A rate changes for each separate class of mail [including] an explanation that will allow mailers to predict with reasonable accuracy the amounts of future scheduled rate changes." The Postal Service is required to file updates to the schedule as appropriate. *See* Rule 3010.7(e). To date, it has filed three such schedules.

- On February 11, 2008 (relating to Docket No. R2008-1)[103] — advising of the next pricing change to be implemented on May 12, 2008, and subsequent changes in **mid-May** 2009 and each subsequent year. The next increase did occur in May 2009, but due to denial of the exigent rate case, the next increase actually occurred later than anticipated, in April 2011.

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[103] http://www.prc.gov/Docs/58/58937/Reg_Pred_Price_Schedule.pdf

- On January 13, 2011 (relating to Docket No. R2011-2)[104] — advising of the next pricing change to be implemented on April 17, 2011, and subsequent changes in **mid-April** of each year. The next increase actually occurred in January 2012, earlier than anticipated by that filing.

- On October 18, 2011 (relating to Docket No. R2012-3)[105] — advising of the next pricing change to be implemented on January 22, 2012 and subsequent price changes in **January** of each year.

Timing of (i) the annual compliance review and (ii) price adjustments can create two type of problems.

First, technical problems in reconciling data arise when each annual compliance report contains (i) costs from a previous fiscal year, and (ii) revenues from two different sets of rates (*i.e.*, those in effect during the early months of the prior fiscal year along with those in effect after the price adjustment). Evaluating compliance using data from two (or more) rate regimes during the prior fiscal years presents a recurring difficulty.

Second, problems arise in unnecessary delay between the issuance of a Commission annual compliance determination and the implementation by the Postal Service of recommendations in that determination. If, for example, price changes for market dominant products were to be noticed on March 15, any Commission guidance issued in late March of the previous year would be nearly a year old. As a practical matter, such timing would allow the Postal Service to ignore the recommendations of the Commission for a full year — when it could argue changed circumstances. The only exception would be if the Postal Service was

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[104] http://www.prc.gov/Docs/71/71549/Not.Schedule.Regular.Rate.Adj..pdf

[105] http://www.prc.gov/Docs/76/76804/Not.Schedule.Regular.Rate.Adj..pdf

directly ordered to make immediate changes under 39 U.S.C. section 3653(c), but this would create a second round of price adjustments.

Valpak has discussed these same problems in prior dockets. *See, e.g.*, Docket No. ACR2009, Valpak Initial Comments, pp. 61-64. Price changes effective October 1 would both (i) implement with reasonable expedition Commission input through the ACR review process, and (ii) cause rates to be in effect for an entire fiscal year, which would minimize the technical comparison issues.

The Postal Service's most recent price adjustments indicate that subsequent market dominant price changes would be in January of each year.[106] This would indicate that the Commission's late March 2012 ACD (a review of FY 2011) could be implemented in prices which would be noticed in October 2012 and effective in January 2013. While this is not as bad as it could be, neither is it as good as it might be.[107]

The Commission's latest statement with respect to timing was in Order No. 987 in Docket No. R2012-3:

> As the Commission mentioned in its Section 701 Report … rate filings in October, November, and December mean that available cost data are more than one year old. When the Postal Service files its ACR in late December, the updated cost data could reveal that workshare discounts were set too low or too high or that a product will no longer cover costs under the new rates. In previous years, the Postal Service filed price

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[106] The Postal Service is required by law to give 45 days prior notice for market dominant price adjustments, but has stated that it plans to give mailers at least 90 days prior notice.

[107] Valpak is fully aware that PAEA allows the Postal Service full discretion regarding implementation of price adjustments.

> adjustments in January after it filed its ACR. Filing price adjustments in the second quarter of the fiscal year ensures that the most up-to-date cost data are available when prices, product cost coverages, and workshare discounts are proposed by the Postal Service and reviewed by the Commission. [Order No. 987, p. 4 (footnote omitted).]

Valpak has a somewhat different view, believing it better if the Postal Service's price notice came two to three months after the most recent ACD issued by the Commission so that the Postal Service can take Commission pricing guidance into account with minimal delay. Having price adjustments incorporate recent Commission recommendations seems more important than the freshness of cost data. As the Commission views its primary concern in a pricing docket to be compliance with the price cap, therefore, it should not be less critical which costs are being used for evaluating a price adjustment. Freshness of cost data makes more sense in the context of an annual compliance review, where the Commission should be reviewing prices for compliance with a broader array of statutory considerations. In the past, the depth and persistence of losses associated with underwater products would indicate that obtaining fresh cost (and revenue) data need not be considered a prerequisite in order for the Commission to address those problems, *e.g.*, each time the Commission has opted to wait for updated cost data, almost invariably the problem seems to have worsened.

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