

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2011)
)
) Docket No. ACR2011

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
REPLY COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2011 ANNUAL COMPLIANCE REPORT
(February 17, 2012)**

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REPLY COMMENTS

Valpak Direct Marketing Systems, Inc. and Valpak Dealers’ Association, Inc. (“Valpak”) submitted Initial Comments on February 3, 2012, and submit the following Reply Comments with respect to the Initial Comments filed by four other commenters, as well as responding to the Postal Service’s Response to Chairman’s Information Request No. 2, Q. 1.

I. AMERICAN CATALOG MAILERS ASSOCIATION

The apparent effort by the American Catalog Mailers Association (“ACMA”) to have the Commission reverse its legal finding in Docket No. ACR2010 that Standard Flats prices violate 39 U.S.C. § 101(d) (FY 2010 ACD, pp. 106-107) must overcome a high hurdle. Although appealed by the Postal Service, the Commission’s factual and legal findings were correct when made, and since then, the coverage of Standard Flats has deteriorated even further, from 81.6 percent in FY 2010 to 79.3 percent in FY 2011.

To refute the validity of Commission’s finding, one would have expected that ACMA bring something new to the table to defend Standard Flats’ continuing — now growing — subsidy, which has exceeded \$2 billion over the past four years. Instead, the ACMA comments stick with the old refrain: that (i) the Commission’s costing methodology is flawed

(for the main reason that Standard Flats costs seem to them to be too high), without offering even one constructive suggestion as to how it could be improved; and (ii) the Postal Service (which grants it pricing favors that continue to rob from other Standard mailers to subsidize ACMA members) has inefficient management.¹ ACMA's Initial Comments present nothing new except for converting a textual argument into a formula-laden appendix.

1. ACMA Fails to Explain Why Proper Pricing Signals Should Not Be Used with respect to Catalog Mailers.

ACMA begins its Initial Comments with some generalities about catalogs:

Through catalogs, distributed mostly through the mail, at **Standard Flats, Carrier Route Flats, and High-Density Flats** rates, ACMA members make a wide range of goods and services available to consumers and businesses.... **The rates** for them, then, **are critically important** to both catalogers and the Postal Service. [ACMA Initial Comments, p. 1 (emphasis added).]

Beyond stating that catalogers use different products and are guided by prices, ACMA offers no insight as to how catalogers use these products — *e.g.*, which product is most relied upon for prospecting versus mailing to established customers, or how prices affect the number of times catalogers mail to prior customers after they cease ordering, or the extent to which catalogers use High Density. ACMA knows that prices give signals to mailers, but does not want proper pricing signals sent to catalogers.

It is well-known that efficient practice in the mailing industry, guided by eligibility requirements and the **signals sent by the**

¹ To be sure, ACMA's Initial Comments do not rise to the level of its previous frontal assault on Postal Service management for incompetence alleged in Docket No. R2010-4 in comments filed by ACMA and other parties opposing the exigent rate case. Docket No. R2010-4, Comments of The Affordable Mail Alliance, *et al.* (Aug. 17, 2010), pp. 14-23, [http://www.prc.gov/ Docs/69/69753/10-08-17%20AMA%20comments.pdf](http://www.prc.gov/Docs/69/69753/10-08-17%20AMA%20comments.pdf).

differences among the various rates, is to control postage bills by splitting mailings among them. For example, a commercial mailer of flats would, as allowed by the size of his mailing, qualify some pieces as Commercial HD Flats, others as Commercial CR Flats, and the remainder as Commercial Standard Flats (the latter having subcategories of its own). [*Id.*, pp. 25-26 (emphasis added).]

Viewing prices as signals to promote more efficient use of resources has been a key consideration in postal pricing for many years. Proper pricing signals would focus price increases on products that have been, and continue to be, deeply underwater, particularly Standard Flats, so as to discourage their use and encourage more use of other profitable products that require fewer resources relative to the price. ACMA never even hints as to why the common-sense pricing in favor of economic efficiency should not be followed — to increase prices for underwater Standard Flats, relative to rates of the profitable Carrier Route and High Density flats products, in order to encourage more use of the money-making flats products and less use of the money-losing flats product.²

2. ACMA’s New Cost Index and Its Assault on Postal Costing Are Not Helpful.

The one new aspect of ACMA’s Initial Comments is its proposed “cost index,” which it claims is “an appropriate way of quantifying cost changes **not due to changes in worksharing.**” *Id.*, p. 2 (emphasis added). ACMA presents a series of graphs comparing a

² Following announcement of the last price adjustment in Docket No. R2012-3, in which the percentage increase in Carrier Route prices exceeded the percentage increase for Standard Flats prices, ACMA itself commented publicly to the effect that Postal Service pricing should have been otherwise. *See* discussion in L.L. Bean Initial Comments, pp. 1-2.

factor price index with rate and cost indices for selected products.³ Actually, ACMA's cost index is a different way of demonstrating that:

- (i) processing of flats is more expensive than letters;
- (ii) unit costs of Standard Flats, the flats product which requires the most processing, have increased faster than other Standard Mail products; and
- (iii) cost coverage of Standard Flats has declined as price increases have failed to match cost increases.

None of this is new — the high costs (and low coverage) of Standard Flats (and Periodicals which ACMA also mentions) have been on display for the last several years.

Comparisons shown in ACMA's graphs form the basis for ACMA's harsh criticisms of the costing system that the Commission and Postal Service, with the help of mailers and other stakeholders, have been developing and refining for over 40 years:

- “[T]he costs are **wrong**.” *Id.*, p. 13, n.18 (emphasis added).
- “Something is **terribly wrong**.” *Id.*, p. 20 (emphasis added).
- “Even if the costs were right in 1998, ... they are **far out of bounds** now.” *Id.*, pp. 23-24 (emphasis added).

However, ACMA approves Postal Service costing systems with respect to the cost index presented for **Carrier Route** (Graph 3), stating that “[t]his graph, though limited, **does not suggest problems with the costing systems**.” *Id.*, p. 10 (emphasis added). With respect to **High Density Flats**, even though mentioned in the introduction to ACMA's Initial

³ Standard Letters (Graph 1, at 5), Standard Flats (Graph 2, at 6), Carrier Route (Graph 3, at 9), Outside County Periodicals (Graphs 4 and 5, at 11 and 13 respectively), unit mail processing costs, 5-digit Automation Standard Letters and Flats (Graph 6, at 16), unit delivery cost, 5-digit Automation Standard Letters and Flats (Graph 7, at 17), and Carrier Route Standard unit mail processing cost and unit delivery cost (Graph 8, at 18).

Comments, ACMA presents no graph showing a cost index, and ACMA levels no criticism whatsoever against the costing system as it applies to High Density Flats.

ACMA mentions, but fails to analyze and fully appreciate, that cost increases for Standard Flats could be due to non-operational causes, such as the: “**requirement to begin prefunding health benefits** for retirees [that] could have effects, depending on associated costing decisions.” *Id.*, p. 21 (emphasis added). Since handling of Standard Flats requires considerably more labor input than does handling of Carrier Route or High Density, and health care benefits are distributed over labor costs, it stands to reason that this extraordinary requirement imposed by the Postal Accountability and Enhancement Act (“PAEA”) could account for some (perhaps a significant portion) of the disproportionate increase in the Standard Flats cost index observed since FY 2006. Inspection of Graphs 2, 4, 5, 6, and 7 shows rather plainly that much of the deviation between the cost index and the factor price index has occurred since the health care prefunding requirement became effective at the end of 2006. Other explanations, such as Flats Sequencing System (“FSS”) costs discussed in Section 3, *infra*, also may be applicable.

While it is helpful when mailers selectively and constructively criticize the results of the established costing system, ACMA fails to give the Commission sufficient reason to ignore the \$2 billion the Postal Service has suffered in cumulative losses recorded by Standard Flats over the past four years. It offers no reason why these 6.8 billion Standard Mail pieces, which constitute 8 percent of all Standard Mail, should make no contribution to institutional costs — especially since Standard Mail as the largest single mail class is now being increasingly relied

on by the Postal Service. ACMA offers no reason to postpone a substantial increase in the coverage of Standard Flats.

3. ACMA Asserts that Excess Capacity Is a Major Source of Increases in the Unit Cost of Standard Flats, but Offers No Evidence to Support Its Position.

ACMA launches three broadsides about excess capacity, which are addressed below:

The results suggest either [a] that the Postal Service is **going backwards technologically**, and installing higher and higher cost processing and delivery systems for flats but not for letters, [b] that **excess costs are being assigned**, or [c] that something is **awry in the costing systems**. The first possibility is not likely and is certainly not something with which mailers should be burdened. The **second and third** are more likely, and they **could be working together**. [*Id.*, p. 24 (emphasis added).]

a. ACMA claims the Postal Service is regressing technologically. ACMA essentially admits that the first of the three possibilities it mentions — *i.e.*, going backwards technologically — is not likely. At the same time, ACMA fails to understand the process by which new technologies are introduced: although technology is generally progressing, it is accompanied by occasional hiccups. Here, start-up problems associated with deployment of the FSS during FY 2010 and FY 2011 may have resulted in somewhat higher unit costs for Standard Flats.⁴ If unit costs of flats processed on the FSS decline as the Postal Service gains more operating experience with the FSS, it could help coverage of Standard Flats to increase slightly. However, the FSS is certainly not the entire story. In 2009, before deployment of the FSS machines began, Standard Flats were already underwater, and by the end of FY 2011

⁴ Comments of Halstein Stralberg incorporated in Time Warner's Initial Comments discuss the possibility that until now the FSS may actually have been causing an increase in the cost of handling flats. Comments of Halstein Stralberg, pp. 8-10 (Feb. 3, 2012).

they had a **cumulative four-year deficit of \$2 billion**. Moreover, using accepted methodology the Postal Service estimates that the rate increase implemented on January 22, 2012 will result in a **coverage of only 84 percent**, and add further to the **cumulative deficit in the amount of \$458 million**. See Response to ChIR No. 2, Q. 1 (Feb. 7, 2012) and CHIR2.Q1.xls in USPS-FY11-45. Established costing demonstrates that Standard Flats continue to be deeply underwater and that significant rate increases are needed.

b. ACMA claims excess capacity costs are being assigned to Standard Flats.

ACMA's assertion that excess capacity costs are being assigned to Standard Flats is reminiscent of arguments raised in previous years by Periodicals mailers about "automation refugees."⁵ It first was argued that Periodicals were receiving excess manual processing in facilities with automation equipment as a way of keeping occupied clerks who otherwise might be idle. Later, the argument evolved to include manual processing in order to meet service standards, because Periodicals often missed the critical entry time for processing on automated equipment. The Postal Service has acknowledged that many facilities had a "Hot 2C" area where extra efforts were made to provide late-entered periodicals with timely delivery.⁶

In this docket, ACMA suggests that excess capacity somehow has crept into the costs of Standard Flats, yet ACMA submits no supporting evidence. Excess capacity might be manifest by unnecessary manual sortation, but ACMA does not indicate whether any costs attributed to

⁵ This term was introduced into the postal lexicon by Halstein Stralberg in a prior docket.

⁶ All of these "Hot 2C" areas are said to have been closed during the latter part of the last fiscal year.

Standard Flats were in the manual cost pool at Management Operating Data System (“MODS”) facilities with automated equipment. Since all Standard Mail can be deferred, where automated equipment exists processing of catalogs can wait until time on the equipment is available. Consequently, there should be no reason for manual processing of automatable Standard Flats to meet service standards. ACMA offers no evidence concerning manual sortation of Standard Flats, and apparently did not investigate. Further, ACMA fails to offer one reason why any such excess capacity costs should creep into (and exaggerate) the cost base of Standard Flats while not doing likewise for Carrier Route or any of the other Standard Mail products.

c. ACMA claims the costing systems have gone awry. ACMA’s third argument is that something must be awry in the costing system.

Figuratively if not literally, **inputs are fed** into spreadsheets, **equations reside in the cells**, the calculate button is pushed, and costs come out. **This crank is turned** until the procedure is changed....

It would seem, then, that **the costs are out of compliance....** We ask respectfully that the Commission look further into this matter. [*Id.*, p. 25 (italics original, emphasis added).]

To assure causality, In-Office Cost System (“IOCS”) tallies are taken in the workplace. For those tallies that indicated employees were working on Standard Flats, was something amiss? ACMA does not say. For any of the other inputs fed into the spreadsheets, is something wrong? ACMA does not say. Do equations residing in the cells contain errors? Again, ACMA does not say. Is something else wrong with the procedure? ACMA does not say. Is “the crank” being turned one way for some products, and another way for other products? ACMA does not say. While boldly asserting that “the relationships are not

reliable,” ACMA gives no credible hint or clue regarding possible sources of any unreliability. One waits in vain for ACMA to complement its broad criticism with any specific positive suggestion. Instead, ACMA would lay the burden of proof on the Commission to demonstrate the validity of the cost estimates that result from the approved costing system. Unsupported allegations do not justify abandoning the accepted methodology and are no excuse for the Postal Service to continue losing enormous sums of money on Standard Flats.

4. ACMA’s Plea for the Commission to Jettison the Entire Costing System Is Unsupported and Should Be Disregarded.

Although ACMA has no problem with Standard Flats being deeply underwater in violation of 39 U.S.C. §§ 3622(c)(2) and 101(d), it does find one area where it contends PAEA is being violated. **According to ACMA**, all existing **costing** for Standard Flats (and Periodicals) **is illegal**:

The cost increases for Standard Flats and Periodicals have been substantially in excess of what can be explained by factor price increases **or in any other way**. For this reason, and for supporting reasons discussed herein, **reliance cannot be placed on these costs ... the costs themselves are out of compliance**. [*Id.*, p. 33 (emphasis added).]

ACMA’s recommendation that the Commission place no reliance on “these costs” and find that “the costs themselves are out of compliance” represents an extreme, unprecedented, and unsupported attack on the accepted costing methodology. It should be rejected out of hand. Enamored with its new index, but lacking credible evidence to support its position, and having no constructive suggestions to offer, ACMA would have the Commission jettison the accepted methodology. In favor of what? It apparently does not care, so long as its subsidy continues.

The existing methodology is not perfect. Over the years, Valpak has observed costing curiosities, even anomalies, and recommended further investigation, and sometimes urged changes. Any methodology is susceptible to further refinement. Each year various changes in methodology are proposed, vetted, and then either approved, modified, or rejected by the Commission. In addition, the Postal Service has underway a broadly conceived Costing Systems Assessment Initiative which could result in significant further improvement in the costing process.⁷ ACMA's vague "conclusion" that the entire costing system is somehow illegal is not constructive, not supported, and should be disregarded.

5. Standard Flats Are Properly Defined as a Product, and Commercial Flats Remain Deeply Underwater even when Viewed Separately.

Unable to demonstrate that the Standard Mail Flats product is above water, ACMA (yet again⁸) asks the Commission to redesignate such products and place them in a "product-like group" that it has cobbled together in a quest to find profitability.

"Standard Flats" is a category designated as a **product**, **currently**.... It includes both **Commercial** Standard Flats and **Nonprofit** Standard Flats.... It is clear that the categories designated as products are **non-homogeneous agglomerations**. However, revenues and costs are estimated for these agglomerations and presented annually in the Cost and Revenue Analysis (CRA) Report.... It might be possible to **jump this hurdle** by considering the savings from a decision not to offer the following **product-like group**: Commercial Standard Flats *plus*

⁷ See, e.g., Memorandum from Postal Service Vice President and Controller Timothy F. O'Reilly to Postal Stakeholders on "Cost System Assessment Project Update" (Feb. 8, 2012). <http://www.postcom.org/public/2012/O%27Reilly%20-%20Costing%20Project%20Update%20%20.pdf>.

⁸ See Docket No. ACR2010, ACMA Initial Comments, pp. 3-7, ACMA Reply Comments, pp. 2-3; Docket No. ACR2009, ACMA Reply Comments, p. 5.

Commercial Carrier Route Flats *plus* Commercial High-Density Flats. [*Id.*, pp. 25-26, 31 (italics original, emphasis added).]

The Commission rejected a similar product grouping proposal in Docket No. ACR2010, stating that “[e]ach product must be evaluated using its own revenues and attributable costs.”

See FY 2010 ACD, p. 93. The idea has no more merit now than it did before.

Lastly, ACMA objects to inclusion of nonprofit flats in the Standard Flats product:

In order to judge whether the rates for Commercial Standard Flats (a component category [of Standard Flats]) comply with title 39, the Commission has looked at the cost coverage for Standard Flats... A mismatch is apparent. That is, the levels of the **revenues and costs of Nonprofit Standard Flats are included but have no relation to the question.** [*Id.*, p. 27 (emphasis added).]

ACMA alleges a “mismatch,” seemingly denying the reality that both nonprofit and commercial flats are handled in a similar manner and have similar cost characteristics.

Although it is true that nonprofit Standard Flats pay a lower rate and have a lower coverage than commercial Standard Flats, even if viewed alone, commercial Flats appear to be deeply underwater. *See* Table I, *infra*. The coverage for commercial Standard Flats was only **85.1 percent** in FY 2011. Thus, a **price increase of 17.5 percent would be needed** just to bring coverage of commercial Standard Flats up to 100 percent, which still (i) would mean no contribution to overhead costs, and (ii) would leave the entire shortfall on nonprofit Standard Flats to be covered entirely by other Standard Mail products.

Table 1
Commercial and Nonprofit Standard Flats
Revenue, Cost and Coverage
(FY 2011)

	(1)	(2)	(3)	(4)
	Revenue	Attributable Cost	Coverage	Volume
	(mill.)	(mill.)		(mill.)
Commercial	2,152.7	2,529.3	85.1%	5,458.9
Nonprofit	<u>338.4</u>	<u>613.6</u>	55.1%	<u>1,324.3</u>
All Standard Flats	2,491.1	3,142.9	79.3%	6783.2

Sources: Columns 1 & 4, FY 2011 Billing Determinants.
Column 2, FY 2011 CRA, prorated by volume.

6. Standard Flats Do Not Pay a Fair and Equitable Share of the Institutional Cost of Postal Operations, Forcing Other Products to Pay Higher Rates.

One section of ACMA’s Initial Comments bears the title: “A case cannot be made that Standard Flats are being cross-subsidized.” ACMA quotes a portion of the Commission’s brief to the U.S. Court of Appeals for the D.C. Circuit that mentions “cross-subsidy,” and then adds:

It is clear that the Commission’s determination hinges on a cross-subsidy existing and being viewed as unfair. The matter of **whether a cross-subsidy can be said to exist, then, is of pivotal importance.** [ACMA Initial Comments, p. 28 (emphasis added).]

Concern over cross-subsidies comes from two directions ... [One] is **whether such pricing is fair to other products.** This question *is* at issue here. [*Id.*, p. 29 (italics original, emphasis added).]

ACMA’s claim that the existence of a cross-subsidy is of “pivotal importance” is a classic red herring. The issue before the court in the pending appeal is the legality of the Commission’s finding that Standard Flats violate one of the central postal policies in the law:

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. [39 U.S.C. § 101(d) (emphasis added).]

The statutory reference is not to “cross-subsidy” but to “fair and equitable” apportionment of “costs” — all postal costs — whether they be considered attributable or institutional.

Operation of the statute can be illustrated by three scenarios where “cross-subsidy” is not “pivotal”:

- a. The Commission is not required to find that a product which does not cover 100 percent of its attributable costs violates this statute.⁹
- b. The Commission could find that costs were being apportioned in violation of this statute even if a product had a coverage over 100 percent and covered its incremental costs, if it believed that there was no good reason why it was not paying a higher share of institutional costs, and this was unfair and inequitable.¹⁰
- c. The Commission could find that costs were being apportioned in violation of this statute if a product had a coverage that was excessive, and this was unfair and inequitable. In fact, since the Commission can look at relative coverages to determine what is fair and equitable, the Commission could find that it violates

⁹ In the past, the Commission has taken this position on all occasions when coverage of a product is below 100 percent, with the single exception of Standard Flats in Docket No. ACR2010.

¹⁰ A commercial advertising product that has a coverage only slightly exceeding 100 percent (*e.g.*, 105 percent) could be considered as not paying a fair and equitable share of overhead costs. Indeed, 39 U.S.C. § 3622(c)(2) establishes “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 ... **plus** that portion of all other costs of the Postal Service **reasonably assignable** to such class or type....” (Emphasis added.)

the statute if certain products are required to pay excessive prices while other comparable products do not even cover their costs.¹¹

In its continuing error regarding cross-subsidy, ACMA makes three false assertions, namely:

- a. that the Commission's concept of the term "cross-subsidy" is misinformed and wrong;
- b. that other products in Standard Mail somehow are better off by having Standard Flats continue to pay rates that do not cover their attributable costs; and
- c. that it is fair and equitable for catalogs using the Standard Flats product to continue paying nothing toward the Postal Service's overhead costs — and also to compel other products to cover some of its attributable costs.

Valpak's sequential response to each such assertion is as follows:

a. The Commission's reference to cross-subsidy is fully accurate. ACMA notes, correctly, that the standard test for cross-subsidy is whether revenues exceed incremental cost. Incremental costs, like attributable costs, are based on causality. ACMA knows full well that the incremental cost of a product includes all attributable costs **plus** any non-attributable costs that also would be avoided if the product ceased to be offered. Therefore, incremental costs are always higher than attributable costs.

Since revenues from Standard Flats covered only 79 percent of attributable costs (and commercial Standard Flats covered only 85 percent of their attributable costs) (*see* Table 1, *supra*), they clearly failed to cover their incremental cost by an even wider margin. Under these conditions, any attempt to show that revenues of Standard Flats exceeded their

¹¹ Valpak has taken this position in Section II of its Initial Comments in this docket. The coverage of High Density/Saturation Letters and High Density/Saturation Flats and Parcels are well above 200 percent, and that of Standard Flats is well below 100 percent.

incremental cost obviously would be an exercise in futility. Perhaps for this reason ACMA makes no attempt to estimate incremental cost, *i.e.*, what non-attributable costs also are caused by the Standard Flats product. In any event, it is clear that neither Standard Flats (nor commercial Standard Flats alone) cover their attributable or their incremental costs. Thus, they clearly are being cross-subsidized in the customary sense of that term.

b. ACMA’s arguments about group product discontinuance make no sense.

ACMA argues that it “makes no sense at all” to give serious consideration to discontinuance of either or both components of Standard Flats. ACMA Initial Comments, p. 30. ACMA does not identify where discontinuance of the product is being considered.¹² Then ACMA claims that the only way to examine the cross-subsidy to Standard Flats is to go beyond the incremental cost of any and all of the flats products used by catalogers and use another, new test.

[A] **burden test** would focus on the financial effect (involving both the revenue loss and the cost reduction) of withdrawing the trio of Commercial Standard Flats, Commercial Carrier Route Flats, and Commercial High-Density Flats (the latter to the extent, at least, that it does not involve geographically targeted mailers, which is a growing extent). Then, in a second step, estimates would be made of the net financial effect of all further volume responses to this withdrawal. [*Id.*, p. 31 (emphasis added).]

¹² Theoretically, if demand for Standard Flats were perfectly elastic, any price increase whatsoever would be tantamount to elimination of the product. But ACMA offers no evidence that demand for Standard Flats is so elastic that the product effectively would be terminated by a price increase that is meaningfully above-average. The existence of such a product has yet to be demonstrated in postal history.

ACMA describes but provides no guidance to implement this new “burden test.” It is profoundly ironic that in its effort to have Standard Flats continue to avoid paying any portion of the institutional cost burden, ACMA raises the issue of what it calls a “burden test.” Indeed, there is another way to view a real burden test — a test that is met by the burden underwater Standard Flats place on other Standard Mail products.

Based on attributable costs alone, the Postal Service’s four-year cumulative loss on Standard Flats exceeded \$2 billion at the end of FY 2011, and is projected to grow by approximately another half billion this year. And the 15-year cumulative loss on Periodicals now exceeds \$5 billion. It is true that the elimination of both underwater products would go far to save the Postal Service. Valpak’s Initial Comments demonstrated that **in the past four years, without underwater products, the Postal Service would have had an operating profit of \$2.3 billion, rather than an operating loss of \$4.3 billion.** Additionally, eliminating these products would have saved all the R&D money spent to develop the FSS, as well as other fixed overhead expenses associated with these expensive flats products.

As ACMA itself points out, “the cost coverage of the duo of Commercial Standard Flats and Commercial Carrier Route combined is [only] 106.5 percent.” ACMA Initial Comments, p. 32. It seems likely that the incremental cost of these flats products — which ACMA makes no effort to estimate — almost surely exceeds their combined revenue by a substantial amount. If Postal Service losses continue to grow unabated, the Postal Service indeed might need to consider a sharp reduction in the number of flats products which it offers. Thus, ACMA’s inquiry — whether the Postal Service would be better off without perennially subsidized Standard Flats — could become pertinent.

c. Products that contribute nothing to the Postal Service’s overhead costs are neither fair nor equitable. In FY 2011, the Postal Service incurred about \$29.5 billion of institutional costs — costs not attributed to any particular product or service. Products that cover their attributable costs and no share of institutional costs can be described as free riders — not contributing to the common good. Products that fail to pay even their attributable costs can be described as free loaders — both (i) not contributing to the common good, and (ii) imposing a profound burden on other mailers.

In FY 2011, competitive products contributed about \$2.3 billion to institutional costs, so in order to break even financially the Postal Service needed a contribution of \$27.2 billion from all market dominant products combined. The attributable cost of all market dominant products was approximately \$34.6 billion, so financial breakeven required an average coverage of 179 percent on all market dominant products. That contribution “target” was not realized, however, as the Postal Service had a revenue shortfall of \$5.1 billion.

All market dominant products combined produced a coverage of only 163 percent in FY 2011. But coverage among the various market dominant products — *i.e.*, the percentage contribution to institutional costs — is not distributed ratably. For example,

- By law, prices for all nonprofit Standard Mail essentially cover only (approximately) their attributable cost; nonprofits are perennial free riders.
- Periodicals have become perennial free loaders. If Periodicals ever achieved the status of free riders by virtue of paying their attributable costs, which they have not done for the last 15 years, the ESCI provision then would limit sharply any contribution to overhead costs and preserve their free rider status.
- Package Services had a cost coverage in FY 2011 of only 94 percent, and it appears unlikely that those products ever will contribute much to overhead costs (the volume of Package Services is comparatively small in any event).

Except for the comparatively small contribution made by competitive products,¹³ the burden of paying all of the Postal Service's remaining non-attributable costs falls on commercial products in First-Class and Standard Mail.

Admittedly, the Postal Service needs to reduce its fixed cost base by several billion dollars.¹⁴ Even then, though, the average coverage on First-Class and Standard Mail combined will need to be around 175 percent. To the extent that the coverage of any product in First-Class or Standard Mail is less than this amount, other products in First-Class or Standard Mail will be required to pay an even higher coverage — or else the Postal Service will not be financially sustainable.

Against this backdrop, ACMA's argument — that it is “fair and equitable” for Standard Flats to drain the Postal Service with its negative contribution — leaves the entirety of the overhead burden to other products and also forces other mailers to pay part of Standard Flats' attributable costs. ACMA also appears to argue that prices for the Standard Flats product satisfy the law's fair and equitable requirement because (i) Standard Flats and Carrier Route have a combined coverage of 106.5 percent, (ii) catalogers therefore pay a combined coverage that in its view represents a fair and equitable share of institutional costs, and (iii) all catalogers use both products. That argument is equally unpersuasive. With a price cap on the Standard

¹³ The current minimum contribution required from competitive products is 5.5 percent. In FY 2011, competitive products were able to contribute about 7.8 percent. Docket No. RM2012-3 is considering increasing this percentage. It would be a mistake for all concerned if the Commission were to set this minimum contribution higher than the competitive market will bear.

¹⁴ See Docket No. ACR2011, Valpak Initial Comments, Section VI.

Mail class of mail and the Postal Service's need to increase prices to the limit of the cap, a low percentage increase on any product forces a higher percentage increase onto other products in the Standard Mail class, some of which already pay coverages in excess of 200 percent.¹⁵ Even if a low percentage increase on Standard Flats were offset fully by a high percentage increase limited to and focused on Carrier Route, the result cannot be considered fair and equitable because even catalogers which use these both products use them in different proportions. As the Commission has stated, "Each product must be evaluated using its own revenues and attributable costs." FY 2010 ACD, p. 93.

II. L.L. BEAN, INC.

Valpak agrees completely with L.L. Bean concerning the need to correct the serious problem of underwater Standard Mail Flats.¹⁶ L.L. Bean comes at the problem from a slightly different perspective than Valpak, as L.L. Bean is a cataloger making heavy use of the Standard Mail Carrier Route flats product. L.L. Bean cites an ACMA survey which shows that two-thirds of catalogs are mailed as Carrier Route flats, and that product generally is used by catalogers for prospecting. L.L. Bean Initial Comments, pp. 1-2. Therefore, the "Postal Service's perverse pricing ... discourages prospecting and impairs the ability of catalogers to

¹⁵ In FY 2011, the coverage for High Density/Saturation Flats and Parcels was 213.0 percent, and the coverage for High Density/Saturation Letters was 220.0 percent.

¹⁶ For example, L.L. Bean and Valpak jointly filed an Intervenor's brief in the U.S. Court of Appeals for the D.C. Circuit (No. 11-1117) supporting the Postal Regulatory Commission in the Postal Service's appeal from the FY 2010 ACD. http://lawandfreedom.com/site/postal/LLBean-Valpak_Brief.pdf.

expand their business — undermining the Postal Service’s objective” of assisting the catalog industry. *Id.*, p. 3. As one of the nation’s premier catalogers, L.L. Bean’s comments should carry great weight.

However, Valpak disagrees with L.L. Bean’s suggestions that since Docket No. ACR2010 is “currently under judicial review, it is not necessary for the Commission here again to issue another formal compliance determination” as the Court’s affirmance would make the Commission’s order “effective and binding on the Postal Service”¹⁷ *Id.*, p. 4. Valpak disagrees that such a finding is “not necessary” for three reasons.

First, on the record, particularly in view of the further deterioration of coverage for Standard Flats from 81.6 percent in FY 2010 to 79.4 percent in FY 2011, a finding of noncompliance for FY 2011 is fully justified — even more justified than last year, if that were possible. *See* Valpak Initial Comments, pp. 53-55.

Second, by statute, unless the Commission makes an express finding of noncompliance, the ACD is said to have made a “rebuttable presumption of compliance.” 39 U.S.C. § 3653(e). Accordingly, it would be theoretically possible for the Postal Service to assert the legal position that a Commission finding in Docket No. ACR2010 somehow lapsed upon issuance of its ACD for FY 2011, replaced by an implicit finding of compliance in the instant docket,¹⁸ and this combination of circumstances somehow would moot the existing litigation.

¹⁷ In its Initial Comments, Valpak strongly urged that the Commission make another finding of noncompliance, based on the Postal Service’s FY 2011 ACR. Valpak Initial Comments, pp. 46-60.

¹⁸ *See, e.g.*, 39 U.S.C. § 3653(b) (“If, with respect to a year, no instance of noncompliance is found under this subsection to have occurred in such year, the written

On the other hand, a finding of noncompliance in the instant docket would ensure that the pending appeal would proceed to a decision.

Third, by failing to make an express finding of noncompliance, an implicit presumptive finding of compliance might affect the possibility that a mailer could file a complaint for violation under 39 U.S.C. § 3662 along the lines of the questioning of Judge Stephen F. Williams during Oral Argument on February 7, 2011, depending on the grounds on which the pending appeal is resolved.

Lastly, although having no problem with L.L. Bean's general statement urging the Postal Service to "reverse its pricing of Carrier Route and Standard Flats" (L.L. Bean Initial Comments, p. 4), Valpak certainly would not want the benefit of remedial price increases for Standard Flats to be directed only to Carrier Route flats. All profitable Standard Mail products which have been required to shoulder the burden of the Standard Flats product over the years should receive some pricing relief. And there is a good reason to focus the relief on the products with the highest coverage: High Density/Saturation Letters (220.0 percent in FY 2010), and High Density/Saturation Flats and Parcels (213.0 percent in FY 2010). By comparison, Carrier Route Flats had a coverage of only 134.8 percent in FY 2010, well below the Standard Mail Class average of 147.6 percent.

determination shall be to that effect.").

III. THE PUBLIC REPRESENTATIVE

A. The PR Misreads the Commission’s Treatment of the Price Cap in Its FY 2010 Annual Compliance Determination.

The Public Representative (“PR”) Initial Comments begin its Financial Condition section with a helpful overview of the statutory structure surrounding the annual compliance review process. PR Initial Comments, pp. 1-2. In an analysis of the structure and performance of the price cap which was imposed by PAEA (*id.*, pp. 6-12), the PR states:

In proceedings reviewing previous ACRs, Public Representatives have expressed concern that the price cap is creating financial dislocation. They further contended that it is within the Commission’s authority to remedy the financial shortfalls by ordering **rates that pierce the price cap**. For instance, in FY 2010 in response to the Commission’s invitation for comments on the Commission’s authority to raise rates in excess of the price cap in order to bring cost coverage to 100 percent, the Public Representative argued, “[T]he Commission has authority to pierce the price cap when a class’s failure to cover attributable costs has become a systemic and perpetual problem.” **The Commission ruled the price cap takes precedence over other objectives and goals of Title 39 and may not be pierced.** [*Id.*, pp. 10-11 (emphasis added, footnotes omitted).]

The PR’s initial analysis is correct, but its conclusion is wrong. To be sure, the Commission stated “PAEA’s price cap mechanism in section 3622(d)(1)(A) takes precedence over the statutory pricing objectives and factors in section 3622(b) and (c). . . .” FY 2010 ACD, p. 18. However, it appears that the PR may have misunderstood the context of the Commission’s statements in last year’s ACD.

First, the Commission was comparing only one factor (section 3622(c)(2)) against the price cap mechanism (section 3622(d)). The Commission stated “The focus in this case [is] on

[one factor —] section 3622(c)(2)’s standing within the statutory pricing hierarchy....” FY 2010 ACD, p. 18. The Commission was looking only at that one factor when it said, “Therefore, to the extent **an objective or factor** with a quantitative component can be seen as competing with the price cap, the price cap has primacy.” *Id.*, pp. 18-19 (emphasis added). The Commission concluded that Periodicals violated only one “objective or factor” — section 3622(c)(2), but did “not find FY 2010 Periodicals rates out of compliance with applicable provisions of chapter 36 or regulations promulgated thereunder [such as 39 U.S.C. § 101(d)].” Therefore, the Commission never decided whether (a) a violation of multiple objectives and factors **or** (b) a violation of 39 U.S.C. § 101(d) — as Valpak discussed in its Initial Comments in this docket (pp. 71-78) — was overruled by the price cap.

Second, although the price cap certainly has primacy in the context of a pricing docket “[w]ith the exception of an exigent rate request and use of banked pricing authority” (FY 2010 ACD, p. 18), it does not bind the Commission in the context of either an Annual Compliance Determination under section 3653 or a complaint docket under section 3662. In Docket No. ACR2010, the Commission expressly saved the question of its remedial authority to pierce the cap, for another day:

The Commission believes it is appropriate to allow time for these measures to be implemented and take hold. Given these considerations, the Commission **need not address the scope of remedial powers under section 3653**. [FY 2010 ACD, p. 17 (emphasis added).]

As both Valpak and previous Public Representatives have analyzed and commented in the past, there are exceptions to the price cap requirement. *See* Docket No. ACR2009, PR Reply Comments, pp. 5-11; Docket No. ACR2010, Valpak Reply Comments, pp. 26-32.

There is no reason to assume the Commission would believe the price cap was designed by Congress to prevent the Commission from protecting the Postal Service from insolvency.¹⁹

The Commission has extremely broad powers in the context of a complaint proceeding, which powers are also available in the event of a Commission determination of noncompliance in an ACD.²⁰ 39 U.S.C. § 3662(c).

In this docket, Valpak set forth the several provisions in section 3622(b) and (c) with which Periodicals prices were not in compliance in FY 2011. *See* Valpak Initial Comments, pp. 71-78. Also, Valpak urged the Commission to make a determination that “rates or fees in effect during [FY 2011] were not in compliance [with section 101(d)].” 39 U.S.C. § 3653(b)(1). Therefore, the “Commission shall take appropriate action in accordance with subsections (c) and [(d)] of section 3662.” 39 U.S.C. § 3653(c).

Section 3662(c) provides as follows:

If the Postal Regulatory Commission finds the complaint to be justified, it shall order that the Postal Service take such action as the Commission considers appropriate in order **to achieve compliance** with the applicable requirements and to **remedy the effects of any noncompliance** (such as **ordering unlawful rates to be adjusted to lawful levels**, ordering the

¹⁹ In the last ACD, the Commission identified explicitly two exceptions to the price cap. One is the unused pricing authority provision which allows the Postal Service to raise rates above CPI to the extent it has not used all of its pricing authority in the past five years, not to exceed 2 percent per year. 39 U.S.C. § 3622(d)(2)(C). The other is an “exigent” case (39 U.S.C. § 3622(d)(1)(E)), where even the Postal Service believes the Commission has this power. *See* FY 2010 ACD, p. 18.

²⁰ Additionally, 10 years after enactment of PAEA (*i.e.*, 2016), the Commission has the “nuclear option,” whereby the Commission can disregard the price cap if “the system is not achieving the objectives in subsection (b), taking into account the factors in subsection (c)....” 39 U.S.C. § 3622(d)(3).

cancellation of market tests, ordering the Postal Service to **discontinue providing loss-making products**, or requiring the Postal Service to make up for revenue shortfalls in competitive products). [Emphasis added.]

The Commission has barely begun to explore the contours of its remedial authority as the Postal Service expressly requested it to do in its FY 2010 ACR (p. 9).²¹ In the FY 2010 ACD, it made a finding of noncompliance and ordered the Postal Service to take certain actions with respect to Standard Mail Flats. Once a finding is made, the Commission faces a Congressional mandate to remedy the problem. Both subsections use the unambiguous word “shall” — “**shall** take appropriate action” and “**shall** order that the Postal Service....” The Commission’s expertise is recognized by PAEA giving it discretion to design a remedy that “the Commission considers appropriate.”

B. The Public Representative Makes Three Points about Standard Flats Pricing which Deserve Comment.

The PR has been a powerful voice in eliminating the problem of underwater products, particularly Standard Flats. He makes three comments worth elaboration.

First, the PR mentions that the Commission has previously ruled “that the financial performance of [Standard Flats] **fails to satisfy 3622(c)(2)**” citing FY 2010 ACD at 103. PR Initial Comments, p. 18 (emphasis added). The PR’s statement is an accurate statement of what the Commission had previously ruled in its FY 2009 ACD (and what it recited in FY

²¹ The Postal Service could be said to have implicitly abandoned its initial request for Commission remedial action during oral argument before the U.S. Court of Appeals for the D.C. Circuit (in No. 11-1117) on February 7, 2012, arguing that the Commission’s role in annual compliance reviews is to ask the Postal Service questions about the basis for its pricing decisions, and then once explained, passively accept those decisions.

2010 ACD at 104). However, the PR did not mention the even more profound finding made by the Commission in its FY 2010 ACD — its first ever finding of noncompliance by a product that “the prices in effect in FY 2010 for Standard Flats **do not comply with section 101(d)** of title 39” as “the long-running contribution shortfall for Standard Mail Flats is an unfair and inequitable apportionment of costs in violation....” *Id.*, at 106.

Second, the PR gives the Postal Service far too much credit when it describes the January 2012 pricing increase of 2.209 percent for Standard Flats was an “above average increase in the price of Flats demonstrates that **the Postal Service is serious** about ending the intra-class subsidy benefitting Standard Flats mailers.” PR Initial Comments, pp. 18-19 (emphasis added). The Postal Service’s noticed rates gave Standard Flats a 2.209 percent increase, only a tiny amount above the 2.041 class average, and less than the percentage price increase given to four of the other five Standard products. As discussed in Valpak’s Initial Comments, this pricing change does not evidence that the Postal Service is serious at all — in fact, it demonstrates that the Postal Service is highly resistant to Commission pricing guidance with respect to Standard Flats.

Third, the PR is clearly correct to urge that the Commission provide the reports about Standard Flats that it previously ordered. PR Initial Comments, p. 1. Valpak concurs completely — also joining with the PR in its urging “the Commission to request from the Postal Service its plan to bring this product back into compliance given the constraints of the price cap.” *See also* Valpak Initial Comments, pp. 58-60.

IV. TIME INC.

Time Inc. (“Time”) submitted Initial Comments incorporating the comments of James O’Brien²² and Halstein Stralberg.²³ Time’s comments are **prospective** — addressing “the ‘efficiency enhancements, network adjustments, and related changes which **could** alter the attributable cost picture for Periodicals’ that the Postal Service management ‘has not yet fully brought to bear.’” Time Initial Comments, p. 3 (quoting the FY 2010 ACD) (emphasis added). Time quotes the Commission’s FY 2010 ACD and the Periodicals Mail Study with respect to “[s]ignificant **opportunities** ... to improve efficiency and reduce costs for Periodicals.’” Time Initial Comments, p. 1 (emphasis added). Looking forward to FY 2012, on three occasions Time mentions its “**hope**” or being “**hopeful**” that cost efficiencies will have a “positive effect on cost coverage” for FY 2012. O’Brien Comments, p. 2 (emphasis added).

Valpak shares Time’s hope “to see improvements in cost coverage as the elimination of Hot 2C becomes standard practice, FSS is fully implemented, and the USPS network consolidation process is completed.” O’Brien Comments, p. 3. However, periodicals mailers’ real hope is that the Commission, once again, will defer a finding of noncompliance, and any

²² The “Comments of James O’Brien on FY 2011 Periodicals Cost Coverage and Service Performance” discuss cost reductions that had been hoped for in FY 2011 but which did not materialize. O’Brien expresses “bitter disappointment” that “Periodicals cost coverage continued to decrease in FY 2011, in spite of significant efforts by the Postal Service and the periodicals industry to drive out costs.” O’Brien Comments, p. 1.

²³ The “Comments of Halstein Stralberg on the Serious Deficiencies of the Proposal Eighteen/ACR2011 Periodicals Flats Model” focus on Periodicals mail processing costs and certain operational considerations.

remedial pricing changes in its FY 2011 ACD using the same basis for deferral of action on Periodicals in the FY 2010 ACD. In the last ACD, the Commission again held out its perennial hope for cost cutting and price signal adjustments. Nevertheless, the cost coverage for Periodicals continued to deteriorate in FY 2011. Moreover, the Postal Service has acknowledged that cost-cutting measures with CPI-based price increases will not bring Periodicals to full cost coverage. The Postal Service's most recent price adjustments in Docket No. R2012-3 again ignored Commission guidance and made no meaningful improvement in price signals for Periodicals. *See generally* FY 2010 ACR, pp. 32-34; Valpak Initial Comments, pp. 68-70. The Postal Service ignored yet again Commission guidance to improve efficiency and reduce costs by increasing the very low passthrough of costs into prices for the most expensive containers to handle (*i.e.*, bundles and sacks). This refusal to send better signals to Periodicals mailers stands in sharp contrast to any professed concern about its "ability ... to use prices to signal efficient behavior." Response to Chairman's Information Request No. 1, Q. 8.

The Commission's statutory duty is to review the **retrospective** compliance of Periodicals' prices during FY 2011 with Title 39, including particularly section 101(d). *See* 39 U.S.C. § 3653. Hopes for **prospective** cost savings sufficient to achieve full cost coverage have been proven elusive for so many years that it would be completely unrealistic to rely on them again. Accordingly, such cost-cutting measures as have been taken should not form the basis for yet another implicit Commission determination of compliance, particularly because the entire class is in violation of 39 U.S.C. § 3622(c)(2). Valpak identified precisely why

Periodicals' prices violate PAEA in several respects (Valpak Initial Comments, pp. 71-78), and nothing in Time's Initial Comments casts doubt on that statutory analysis.

Finally, although it may seem that breakeven from the Periodicals class is unattainable, it certainly will never be attained unless it is sought by the Commission's remedial order.²⁴ Moreover, even breakeven is too low a bar. The Commission's remedial action is not limited merely to bringing such a product to the point where it covers costs, it extends to where the product makes at least some contribution to institutional costs, under 39 U.S.C. § 3622(c)(2). And, the Commission is required to set prices to achieve some level of restitution for prior losses by the Postal Service. 39 U.S.C. § 3662(c) requires 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.**" (Emphasis added.) In other words, after a finding of noncompliance, the Commission's remedial order is **first** "to achieve compliance" by prices which both **cover costs** and **make a contribution** to institutional costs, and **then undo the financial harm** the Postal Service has suffered from past noncompliance (*e.g.*, the \$608.9 million loss in FY 2011 plus ongoing losses currently being incurred). The imperative verb "shall" in section 3662(c) along with the conjunction "and" permit of no other interpretation of that subsection of the statute.

²⁴ The Commission's authority to order remedial rates above the cap for the Periodicals class is discussed in Section III.A, *supra*.

V. POSTAL SERVICE RESPONSE TO CHIR NO. 2

The Postal Service's response to Chairman's Information Request No. 2, Q. 1 was filed on February 7, 2012, after the deadline for filing Initial Comments, so this is the first occasion that Valpak has had to respond to it.²⁵

In response to Chairman's Information Request No. 1, Q. 9, when explaining steps the Postal Service has taken and its plans to reduce the subsidy to the Flats product in Standard Mail, the Postal Service stated:

In FY 2011, the Standard Mail Flats shortfall was \$652 million. The Postal Service's working plan includes operational efficiencies to reduce costs as well as above-average price increases to close the remaining gap. In Docket No. R2012-3, Standard Mail Flats received an **above-average 2.2 percent** price increase. [Postal Service Response to ChIR No. 1, Q. 9 (Jan. 27, 2012) (emphasis added, footnote omitted).]

The response to Chairman's Information Request No. 2, Q. 1 (filed Feb. 7, 2012) brought perspective to that "above average" increase for Standard Flats put into effect on January 22, 2012. Although the coverage of Standard Flats is increasing by virtue of the minimally "above-average" 2.2 percent price increase, the **coverage of every other product in Standard Mail is expected to increase as well**, as can be seen from column 3 of Table 2:

²⁵ The question in the Chairman's Information Request No. 2 addressed herein was suggested to the Commission by Valpak in its Motion for Issuance of Information Request (Jan. 30, 2012).

Table 2
Estimated FY 2012 Cost Coverage for Standard Mail

	(1) 2011 Cost Coverage	(2) 2012 Cost Coverage	(3) Increase
Letters	184.1%	185.4%	1.3%
Flats	79.3%	83.9%	4.6%
Not Flat-Machinables and Parcels	84.9%	89.7%	4.8%
Carrier Route	135.3%	147.4%	12.1%
H-D and Saturation Letters	220.0%	222.0%	2.0%
H-D and Saturation Flats and Parcels	213.0%	214.7%	1.7%

For all of the four profitable products in Standard Mail, the coverage increases shown in column 3 are an indication of the ever greater extent to which each of those four products is being called upon to support the ongoing subsidy provided to the unprofitable products.

Virtually all of the commercial products in Standard Mail consist of advertising material, and all advertising aids commerce and the economy. There is no rational basis for giving such preference to some advertising material at the expense of other advertising material. Within Standard Mail, the Postal Service continues to punish its most profitable products in order to subsidize sizeable continuing losses on Standard Flats. As a matter of public policy, the Postal Service should endeavor to keep the playing field as level as possible among competing firms, such as advertisers and catalogers. Using its pricing flexibility to tilt the field to the extent that some advertisers and catalogers must pay some of the attributable costs of a favored subset of catalogers is gross abuse of that Congressionally granted flexibility. The Postal Service's *de minimis* January 2012 price increase for Standard Flats

defies the Commission's finding of noncompliance in Docket No. ACR2010 and should be found wholly inadequate.

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