Postal Regulatory Commission
Submitted 1/31/2014 3:55:26 PM
Filing ID: 89089
Accepted 1/31/2014

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2013	)))	Docket No. ACR2013

VALPAK DIRECT MARKETING SYSTEMS, INC. AND VALPAK DEALERS' ASSOCIATION, INC. INITIAL COMMENTS ON THE UNITED STATES POSTAL SERVICE FY 2013 ANNUAL COMPLIANCE REPORT

(January 31, 2014)

William J. Olson
Jeremiah L. Morgan
John S. Miles
WILLIAM J. OLSON, P.C.
370 Maple Avenue West, Suite 4
Vienna, Virginia 22180-5615
(703) 356-5070

Counsel for:
Valpak Direct Marketing Systems, Inc.
and Valpak Dealers' Association, Inc.

TABLE OF CONTENTS

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2013	)))	Docket No. ACR2013

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
INITIAL COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2013 ANNUAL COMPLIANCE REPORT**
(January 31, 2014)

On December 27, 2013, the United States Postal Service ("USPS") filed its "United States Postal Service FY 2013 Annual Compliance Report" ("ACR"), which is required by 39 U.S.C. § 3652(a) to be filed within 90 days after the end of the fiscal year. On December 30, 2013, the Postal Regulatory Commission ("Commission") issued Order No. 1935, "Notice of Postal Service's Filing of Annual Compliance Report and Request for Public Comments," seeking initial comments by January 31, 2014, and reply comments by February 14, 2014. The Commission's Annual Compliance Determination ("ACD") is expected in late March 2014, pursuant to 39 U.S.C. § 3653(b).

Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") hereby submit these joint initial comments on the FY 2013 ACR in response to the Commission's Notice.

COURSE OF PROCEEDINGS

The Commission issued Order No. 1935, commencing proceedings in this docket, and inviting:

> public comment on the Postal Service's FY 2013 ACR and on whether any **rates or fees in effect during FY 2013** (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; 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. 1935, pp. 5-6 (emphasis added).]

On January 22, 2014, Valpak filed a Motion for Issuance of Information Request, seeking additional information related to Standard Mail Flats and negotiated service agreements. On January 27, 2014, the Commission incorporated Valpak's requests into Chairman's Information Request ("ChIR") No. 4. Responses to those questions are required to be filed by February 6, 2014, which is after the date for filing these Initial Comments. Accordingly, Valpak will reserve the right to file Reply Comments on matters that are being addressed in those and other responses to ChIRs.

INTRODUCTION

Docket No. ACR2013 is the seventh Annual Compliance Review under the Postal Accountability and Enhancement Act ("PAEA"). As the Commission undertakes its review, it needs to refocus on its role in the statutory scheme established by Congress to ensure that it is properly fulfilling its role under the statute.

Congress required the Postal Regulatory Commission to conduct, *inter alia*, an annual review of the Postal Service's compliance with the policies of Title 39 because it knew that it could not confer monopoly[1] status on the Postal Service and leave it free of regulation. *See* 39 U.S.C. section 3653(b).

It did not matter in the slightest to Congress that the U.S. Constitution authorized Congress "to establish Post Offices, and post Roads" (Article I, Section 8, Clause 7) or that the Postal Service is considered "an independent establishment of the executive branch of the Government of the United States." 39 U.S.C. § 201. The Postal Service could not be trusted to govern itself. It is a peculiar type of institution — a government agency regulated by another government agency.

As such, the Postal Service is not entitled to demand deference from the Commission as to its compliance with Title 39 simply because it is a government agency. A federal court might defer to the judgment of the Commission on certain matters, but the Commission fails to do its job if it defers to the supposed "business judgment" of the Postal Service.

---

[1] In fact, the Postal Service has been conferred with at least two monopolies, and many other statutory benefits and preferences. *See generally*, U.S. Postal Service, Universal Service and the Postal Monopoly: A Brief History (Oct. 2008). http://about.usps.com/universal-postal-service/universal-service-and-postal-monopoly-history.pdf

Under PAEA, the Commission and the Postal Service are certainly not "partners" as is often said. Indeed, there is danger in too many informal contacts occurring between the Commission and the Postal Service. The Commission is "the regulator" (indeed, the Commission's name was changed to confirm this role), and the Postal Service is "the regulated."

The fact that PAEA grants the Postal Service a measure of "pricing flexibility" (39 U.S.C. § 3622(b)(4) and (c)(7)) does not mean that prices set by the Postal Service are entitled to deference. Postal Service pricing is lawful only if it complies with Title 39 — and determining compliance is a responsibility that is bestowed not on the Postal Service, but on the Commission.

In granting the Postal Service greater authority over Competitive Products, Congress recognized that the Postal Service was more likely to have and abuse its market power over Market Dominant Products. Therefore, the Commission has a special duty to oversee and protect mailers using Market Dominant products, such as Standard Mail.

Congress entrusted the Commission with the power to not only conduct a review and write a report, but once a problem is found, it then is required to order the Postal Service to remedy it. 39 U.S.C. §§ 3653(c) and 3662(c).

In six prior ACR's, the Commission has found a statutory violation only with respect to Standard Flats, in only Docket Nos. ACR 2010 and ACR2011 (and possibly ACR2012). The essence of the violation was that under Postal Service pricing, prices charged Standard Flats were too low, and prices charged to other Standard Mail products were too high.

From an economic perspective, highly profitable products were being required to cross-subsidize deeply unprofitable products. Pricing is used to send signals to the market to encourage the entry of mail in a manner that the Postal Service can efficiently handle. The deliberate underpricing of Standard Flats sends erroneous price signals, encouraging mailers to enter mail that the Postal Service cannot handle in an economically efficient manner — *i.e.*, at a cost that is less than the price paid.

From a business perspective, virtually all Standard Mail is fundamentally the same — advertising — and yet different advertising products were being charged prices which reflected grossly disparate coverages. In some cases, these cross-subsidies are extracted from businesses which compete with the very businesses they are forced to subsidize.

From the Postal Service's perspective, underwater products not only lose money, but they also fail to contribute anything to institutional costs. And, higher prices than necessary on profitable products drives away highly profitable volume. Including RHBF payments, only about half of postal costs are attributable. Therefore, the average products must be required to pay an average cost coverage of well over 150 percent. In addition to not paying their own costs, Standard Flats pay no coverage.

In FY 2013, inequitable and unlawful Standard Mail pricing has gotten worse, not better. Indeed, the cost coverage for profitable High Density/Saturation Letters used by Valpak has increased 13.6 percentage points, while the cost coverage of unprofitable Standard Flats has increased only 4.0 percentage points. Moreover, in one year, the differential between the Standard Mail product with the highest coverage (High Density/Standard Letters) and the lowest coverage (excluding Parcels which have negligible volume) has grown from 141 percentage points to almost 151 percentage points.

Standard Mail Products
FY 2012-FY 2013 Cost Coverage

	FY 2012 Cost Coverage	FY 2013 Cost Coverage	Change
HD/Sat Letters	222.2%	235.8%	13.6%
HD/Sat Flats & Parcels	217.3%	229.0%	11.7%
Carrier Route	130.8%	133.4%	2.6%
Letters	178.9%	189.0%	10.1%
Flats	80.9%	84.9%	4.0%
Parcels	85.5%	64.3%	-21.2%
EDDM-R	N/A	359.9%	N/A

The Commission's remedial order for Standard Flats mentioned both cost cutting and price increases as part of the remedy. Of course, cost cutting is something that may or may not occur, and it is now clear that the costs of Standard Flats will not be declining much anytime soon. *See* Section VI, *infra*. Therefore the pricing aspect of the Commission order becomes critical.

Moreover, the pricing aspects of the Commission's remedial order in the FY 2010 ACD have been disregarded and frustrated by the Postal Service. The Postal Service claims that compliance with the Commission order for Standard Flats would cause it to lose money due to the peculiarities of a price cap regime. That is a bogus response for two reasons. First, the Commission cannot sanction rates it has found to be unlawful, even if it causes the Postal

Service to make less money. Second, the Postal Service's claims about how to maximize contribution under a price cap have now been debunked. See Section II and Appendix, *infra*.

In the past, the Commission has largely backed off from requiring compliance with its own order. The recent decision of the U.S. Court of Appeals in the Gamefly case has clarified that the Commission has no discretion to enter a remedial order that does not fully remedy the problem. *See* section IV, *infra*. Now is the time for the Commission to use its full range of remedial powers to ensure compliance with its own order.

The Commission has broad enforcement powers in Annual Compliance Reviews — the same powers that it has in reviewing and remedying unlawful rates in complaint cases:

> (c) Action Required if Complaint Found To Be Justified.— 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 [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**, ordering the 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). [39 U.S.C. § 3662(c).]

Congress recognized that some products would become "loss-making products" and clearly provided that the Commission could "discontinue providing loss-making products." In this section, **all "loss-making products"** were associated with "unlawful rates."

The Commission is required to order the Postal Service actually "to **achieve compliance**" not just "to address compliance" in a small and piecemeal manner. *Id.* (emphasis added). And, the Commission's order must "**remedy the effects** of any noncompliance...." *Id.* (emphasis added). The Commission has power to order that "unlawful rates ... be

adjusted to lawful levels" and even has the power to order the Postal Service "to **discontinue** providing loss-making products…." *Id.* (emphasis added).

Tough times are not all bad, because they expose latent business mistakes which otherwise would have continued unnoticed. For the Postal Service, these mistakes include bad pricing. No exigent rate case would have been necessary if the Postal Service had properly used its pricing flexibility. As shown in Table III-2, since enactment of PAEA, the Postal Service has now managed to accumulate losses on underwater products in the amount of an astounding $8.6 billion. As shown in the CRA, USPS-FY13-1, Postal Service pricing decisions added $1.0 billion or so to the cumulative loss from its underwater products in FY 2013 alone. The prior loss of $8.6 billion on underwater products is well over twice the $2.8 billion loss in contribution attributed to the 2007-2009 recession. Commission Order No. 1926, p. 106. Had the Postal Service reduced those prior losses by only half, by the end of FY 2013 *ceteris paribus* its liquidity would have increased by almost $4.0 billion. The Postal Service's liquidity shortfall is thus seen to be a problem largely of its own making due to pricing. *See* Section III and IV, *infra*.

In the past, some mailers thought, or at least argued, that the price cap would protect them from Postal Service profligacy in pricing, as losses from underwater products could not be imposed on them due to the protection of the price cap. With the exigent rates approved in Docket No. R2013-11, all mailers will now suffer the consequences of the arguments they presented to the Commission to defend broad Postal Service "pricing flexibility." With the exigent rate case, the cap can be seen as providing mailers with no long run protection from Postal Service excess. If the Postal Service loses money, sooner or later, mailers will be required to pay higher rates that substantially exceed CPI. Presumably at least those mailers who are not deeply subsidized under Postal Service pricing now know better.

The Postal Service also states that its current business model is not financially sustainable under a price cap regime accompanied by declining volume.

> P.L. 109-435 generally limits price increases on our Market-Dominant services to the rate of inflation as measured by the CPI-U. However, our costs are not similarly limited…. We believe that **continuing productivity improvements,** by themselves, **will not be sufficient to address the challenge presented by declining volumes and revenues and the regulatory price cap, nor will revenue enhancements keep pace with increased cost structures.** [2013 Form 10-K, p. 10 (emphasis added).]

The crisis is real. To address that crisis, the Postal Service represented to the reviewing U.S. Court of Appeals for the District of Columbia that it is pursuing a central financial goal:

> The Postal Service's goal at this time in its history must be **to maximize contribution**, not reduce it. [Brief of Petitioners in Docket No. 11-117, U.S. Postal Service v. Postal Regulatory Commission, 676 F.3d 1105 (D.C. Cir. 2012) (emphasis added).]

Sadly, the Postal Service has not operated in accordance with its representations to this federal court. The Commission's role is to ensure that it does. Even with a 4.3 percent above-cap price increase in the offing, at the end of FY 2013, the Postal Service acknowledged its need for greater liquidity:

> We continue to suffer from a severe lack of liquidity. We held unrestricted cash of $2.3 billion and $2.1 billion as of September 30, 2013 and 2012. These cash balances represent approximately 9 days and 8 days, respectively, of average daily expenses. [2013 Form 10-K, p. 44. *See also* Docket No. R2013-11, testimony of witness Nickerson.]

Yet the Postal Service refuses to order a call to General Quarters, in either pricing (*see* sections III and IV, *infra*) or cost cutting (*see* section VI, *infra*). An exigent rate case would not have been needed if the Postal Service had aggressively sought to make necessary cuts in its door-delivery expenses, which likely it soon will be forced to do by Congress. *See* Section VI, *infra*. Many are wondering if the Postal Service really would prefer rate increases to effective cost cutting.[2]

Plunging First-Class Mail volumes will continue into the future, aggravated by the exigent rate increase. The financial future of the Postal Service is not bright. *See* section I, *infra*. The Postal Service appears to hope that when the financial crisis mandates Congressional action, Congress will reduce the role of the Commission. The Postal Service has requested Congress to enact a number of initiatives designed to have this effect. Comprehensive Statement of Postal Operations, p. 74.

In the near future, if the Commission does not act, Congress likely will be required to bail out the Postal Service. When Congress asks how this happened, it will want to know how and why the Commission, vested with all the authority it needs to ensure compliance with Title 39, choose not to do so. Indeed, proposals are being advanced in Congress which would strip the Commission's powers, not because they have been misused, but because they have not

---

[2] *See*, *e.g.*, K. Howell, "Postal Service slow to cut costs, quick to raise price: Lawmakers may force cuts," The Washington Times (updated Jan. 31, 2014). http://www.washingtontimes.com/news/2014/jan/29/postal-service-opts-for-stamp-hike-over-deeper-spe/

been used as intended. Such proposals would give the Postal Service unregulated authority over pricing, which could be expected to lead to more abusive pricing.[3]

INITIAL COMMENTS

I. Postal Service Finances Remained Deeply Troubled in FY 2013,

FY 2013 could not be described as a good year financially for the Postal Service, even though it reported an operating profit of $623 million on its 2013 Form 10-K.[4] Indeed, "[i]n FY2013, the Postal Service [recognizes that it] continued to face an ongoing fiscal and liquidity crisis." FY2013 Comprehensive Statement on Postal Operations, p. 74.

A. FY 2013 Financial Results.

The Postal Service reported a net loss of almost $5.0 billion in FY 2013, but this amount **includes** this year's $5.6 billion charge for prefunding future Retiree Health Benefits Fund ("RHBF") payments. The Postal Service publicizes that $5.0 billion number, presumably to convince Congress to enact postal reform, and the media generally follows along. However, Valpak's comments on prior Postal Service ACRs have argued that operating profit/loss is the most appropriate overall financial benchmark for analysis, and Valpak will continue that practice in these comments. Operating profit **excludes** the statutorily mandated, and unrealistically high, RHBF payments.

---

[3] M. Berner, "Don't give the USPS a blank check to exploit its monopoly powers: return this bill to sender, Roll Call, Commentary (Jan. 29, 2014). http://www.rollcall.com/news/dont_give_the_usps_a_blank_check_to_exploit_its_monopoly_powers_return_this-230478-1.html?zkPrintable=true

[4] *See* 2013 Form 10-K, p. 21 (net loss of $4,977 million less RHBF expense of $5.6 billion). Table I-1 shows the operating profit to be $790 million based on other data in the Form 10-K.

Even the Postal Service's reported operating profit of $623 million is deceptive, as the Postal Service used cash flow from depreciation to fund operations, and has not fully funded replacement of its capital base. Consequently, even excluding arbitrary financial burdens imposed by Congress such as RHBF payments, the Postal Service cannot be said to be operating currently in a long-term sustainable mode.

Moreover, towards the end of FY 2013, the Postal Service's liquidity had declined to such a low point that the Governors authorized the Service to institute an exigent rate case. *See* Docket No. R2013-11 (Sept. 26, 2013). The mere filing of an exigent rate case sends a clarion call that all is not well with respect to Postal Service finances. Indeed, the Commission accepted the Postal Service's liquidity crisis as necessitating the exigent request.

B. First Class Mail Volume Trends, and Financial Implications Thereof.

The ACR reveals that highly profitable First-Class Mail volume continued its rather precipitous decline in FY 2013. The ACR states that:

> The **decline in First-Class Mail volume continues, but at a slowing rate**: 6.6 percent in FY2010, 6.4 percent in FY2011, 5.6 percent in FY2012, and 4.2 percent (or 2.9 billion pieces) in FY2013. [*Id.*, p. 10 (emphasis added).]

However, the Postal Service's representation about First-Class volume trends in the ACR is from a strictly backward view and is somewhat misleading. Looking ahead, the FY 2014 Integrated Financial Plan ("IFP") assumed (correctly) that the exigent rate increase would be approved by the Commission.[5] On the basis of that approval, current trends, and price elasticity, the IFP projects a further **decline in First-Class Mail of 6.4 percent in FY 2014.**

[5] It is now subject to appeals by both mailers and the Postal Service.

FY 2014 IFP, pp. 3-4. The 6.4 percent decline in mail volume constitutes a **further loss of about 4.2 billion First-Class Mail pieces,** as well as the contribution to fixed costs which those pieces represent. In no way does a projected decline in First-Class Mail volume of 6.4 percent in FY 2014 reflect a "slowing rate" of decline. If the decline in First-Class Mail materializes as expected, and the Postal Service does not change its pricing and cost-cutting strategies, the Postal Service will continue its gradual, unabated descent toward, at best, insolvency, but possibly a death spiral.[6] Price increases from the exigent rate case might postpone the inevitable, but they might also hasten an irreversible decline in profitable mail volume and a slide into hopeless insolvency, depending on price sensitivity of mailer demand. Should the Postal Service convince the U.S. Court of Appeals for the District of Columbia Circuit that it is entitled to over $20 billion in additional contribution as a result of the 2007-09 recession, the end of the Postal Service as an independent entity could be in sight. Order No. 1926, p. 85. The FY2013 Comprehensive Statement on Postal Operations states (correctly) that "the long-term financial condition of the Postal Service remains precarious." *Id.*, p. 46.

Probably the most critical indicators of future Postal Service finances are trends in volume, most especially diversion of the Postal Service's most profitable volume to the Internet. Those trends were brought to light in the exigent rate case. There, the Postal Service's technique of using "intervention variables" sponsored by witness Thomas E. Thress helped improve the statistical fit of the data. Most of those interventions, however, lack any fundamental causal analysis or economic rationale; hence they provide a weak basis for longer-

---

[6] A death spiral occurs when attempts to raise prices and increase profit has the counterproductive result of still less volume and even deeper losses.

term extrapolation or projection, as the Commission noted. *See* Order No. 1926, p. 83. Volume losses on account of electronic diversion appear to be irreversible, and the forces continuing to drive diversion of First-Class Mail need to be better understood because even the Postal Service's plans for the future assume substantial First-Class Mail volume that may never materialize.

However, we do know for certain that since FY 2007, First-Class Mail volume has declined by 30 billion pieces. The 2013 Form 10-K states:

> Correspondence mail has long been a declining part of mail volume. With the availability of e-mail and other internet-based forms of communication, such as e-cards and social networking, and inexpensive telephone service, **there is little chance that the decline in correspondence mail will be reversed.** [*Id.*, p. 10 (emphasis added).][7]

If diversion continues at that rate and results in the loss of another 30 billion pieces of First-Class Mail during the next seven years, the Postal Service would not be able to pay any of the liabilities on or off its balance sheet, and survival of the Postal Service could depend upon a gigantic taxpayer bailout, potentially in the range of $100 billion. Although each ACD is only a one-year retrospective review, important trends in the decline of First-Class Mail volume must be viewed as **serious risk factors for the future, necessitating that meaningful action be taken now**.

---

[7] Because the SEC rules are more strict in requiring full disclosure, the Postal Service's negative trend in the volume of First-Class Mail is more fully disclosed in the Form 10-K, while the longer-run implications beyond 2014 are almost entirely omitted for the Postal Service's ACR. The Commission should focus on the more candid Form 10-K disclosures, recognizing that losses of profitable mail may materialize much sooner than anticipated in the Postal Service's ACR.

Moreover, during the course of the recent exigent rate case, mailers claimed that the Postal Service was seriously underestimating the elasticity of demand, and hence rate increases in excess of inflation could cause a sharper decline in volume than the Postal Service predicts. Rebuttal testimony by the Postal Service rejected those views, but at this point no one really knows how mailers will react (although certainly not positively). Soon enough, though, we will know whether mailers' prognostications or econometric forecasts relied upon by the Commission are more correct. In essence, the message from mailers in that docket was that Postal Service prices are pushing mail to the brink of irrelevancy, or beyond. Should volume of profitable mail suffer greatly from the exigent price increase, then another exigent case will seem necessary. However, market forces then might preclude such a further exigent rate case, because price increases that exceed inflation likely will be seen to drive the Postal Service further down the path to a true death spiral.

In the 2013 Form 10-K, the Postal Service states the problem as follows:

> We anticipate that total mail **volume will continue to decline in future years** due to the continued decline of First-Class Mail volume and relatively flat Standard Mail volume. The expected continued **decline of First-Class Mail, our most profitable product, will pose a significant challenge.** [*Id.*, p. 24 (emphasis added).]

In general, price increases in excess of inflation are counterproductive because, should elasticity turn out to be higher than presumed, in order for the Postal Service to survive as a financially independent organization, it will have no option but to effect major and rapid reductions in costs, including most especially its very large fixed delivery costs (*see* Section VI, *infra*). It also will have no option but to raise rates for underwater products (*see* Sections

III and IV). Of course, the Postal Service should be taking both of these steps now, but it is not. That puts the burden on the Commission as the regulator to mandate the Postal Service take steps to avert disaster.

C. Standard Mail Cannot Generate Sufficient Contribution to Cover Fixed Costs.

As volume of First-Class Mail continues to decline, the Postal Service must find sources of revenue to pay for its large overhead.[8] In FY 2013, fixed costs represented about 45 percent of total costs, or about $33 billion.[9]

Standard Mail is a workhorse class, but it is not First-Class Mail. The FY 2013 ACR states that:

> As a class, Standard Mail covered its attributable costs and contributed significantly [$6.364 billion] to institutional costs. [FY 2013 ACR, p. 17.]

It is simply inconceivable that Standard Mail will be able to offset the financial loss from further declines in the volume of First-Class Mail, for the following reason:

> To compensate for the loss of one piece of First-Class Mail, Standard Mail must increase by approximately three pieces. Shipping and Packages, International Mail, and other categories are not expected to grow significantly enough to replace the

---

[8] It is highly unlikely that new revenue will come from new products. Market Dominant NSAs have been disastrous for the Postal Service and other products like EDDM may be growing at the expense of other mail, likely shared mail. Cannibalization is not a good strategy for growth.

[9] The FY 2014 IFP projects that gross revenue from First-Class Mail will decline by $0.6 billion, from $28.1 to $27.5 billion. *Id.*, p. 4. Thus, total revenue from First-Class Mail will be substantially below the fixed overhead costs. Unless the Postal Service can reduce its fixed costs quite substantially and rather quickly, it soon could face another liquidity shortage.

> contribution associated with the decline of First-Class Mail.
> [2013 Form 10-K, p. 24.]

Particularly in view of the across-the-board 4.3 percent increase just imposed on all Standard Mail products on January 26, 2014, on top of the 1.7% CPI increase, the prospect of any compensating volume increase for that class would appear to be remote at best. The Postal Service acknowledges this reality, as its 2013 Form 10-K predicts **relatively flat** Standard Mail volume.

Products other than Standard Mail are even less capable of paying any meaningful share of the fixed cost burden. Faced with these realities, the Postal Service will need to move aggressively on three fronts. First, it will need to move aggressively to maximize contribution available within the price cap; *see* Sections II-IV, *infra*. Second, it also will need to reduce aggressively those fixed costs that are within its control; *see* Section VI, *infra*. Finally, it will need Congress to enact some, probably most, of key cost-reducing initiatives. *See* FY2013 Comprehensive Statement of Postal Operations, p. 74. Otherwise, the Postal Service's "ongoing fiscal crisis" will worsen, and much sooner than expected.

Like certain financial institutions, the Postal Service may be considered by Congress to be "too big to fail." Along this line, the 2013 Form 10-K states that: "Disruption of the mail would cause hardships to the public and to the business and banking sectors and could cause some businesses to shut down. **Therefore, it is unlikely that, in the event of a cash shortfall, the Federal Government would allow us to significantly curtail or cease operations.**" *Id.*, p. 46 (emphasis added). The Postal Service may be relying on a congressional bailout to pay for its discriminatory pricing and inadequate cost cutting.

However, the Commission is the regulator and must do its job. It should be the Commission's primary role to ensure that this fate does not befall the Postal Service, mailers, and taxpayers.

Table I-1
Postal Service Operating Revenue and Expenses
FY 2007 – FY 2013
($, millions)

	FY '07	FY '08	FY '09	FY '10	FY '11	FY '12	FY '13
1. Operating Revenue	74,778	74,932	68,090	67,052	65,711	65,223	67,318
2. Operating Expenses, Ex-Retiree Health Benefits	70,021	70,331	68,440	67,679	68,193	67,235	63,678
3. Op. Profit (Loss) Before Retiree Health Benefits	**4,757**	**4,601**	**(350)**	**(627)**	**(2,482)**	**(2,012)**	**3,640**
4. Health Benefits for Current Retirees	1,726	1,807	1,990	2,247	2,441	2,629	2,850
5. Net Op. Profit (Loss), excluding RHBF	**3,031**	**2,794**	**(2,340)**	**(2,874)**	**(4,923)**	**(4,641)**	**790**
6. Funding of RHBF	8,358	5,600	1,400	5,500	------	11,100	5,600
7. Seven-year net **operating loss**, excluding RHBF							8,163
8. Seven-year cost of RHBF							**37,558**
9. Seven-year total **reported loss**							45,721

Sources: USPS FY 2013 10-K, pp. 21, 27; USPS FY 2012 10-K, p. 78; USPS FY 2011 10-K, pp. 80 and 89, n.7; and USPS FY 2009 10-K, pp. 63 and 71.

II. The Postal Service Has Misused Its Pricing Flexibility to Set Standard Mail Prices in Ways which Fail to Maximize Contribution under a Price Cap Regime.

As we enter this Annual Compliance Review, the Commission's finding that Standard Flats prices are out of compliance with Title 39, made in Docket No. ACR2010, expressly renewed in Docket No. ACR2011, and implicitly renewed in Docket No. ACR2012, remains in effect. Although the Commission's remedial order to the Postal Service to correct that statutory violation continues in effect, the problem continues, only slightly abated. The Postal

Service is unmoved by the need to send correct price signals to mailers so they can prepare and enter mail in ways the Postal Service can efficiently handle. The Postal Service is completely insensitive to mailers of highly profitable Standard Mail products, also advertisers, who must pay more so mailers of Standard Flats can pay less. The Postal Service shows no respect for compliance with Commission orders. The Postal Service does not care that similar advertisers pay grossly disproportionate coverages, ranging from the 84.9 percent paid by Standard Flats to the 235.8 percent paid by High-Density/Saturation Letters used by Valpak. The Postal Service does not care that the spread between these Standard Mail products grew from 141.3 percent in FY 2012 to 150.9 percent in FY 2013 alone. The primary reason advanced by the Postal Service for its dogged resistance to the Commission's remedial order is its subjective belief that compliance with the order would harm its finances due to peculiarities of setting rates under a price cap regimen. *See* Docket No. R2013-11, Response of Taufique to POIR No. 11, Question 8. The credibility of the Postal Service's rationale has been put into serious question as it refused to give an above-average increase to Standard Flats in Docket No. R2013-11, where the cap did not apply.[10] Thus far, the Commission has not pushed its remedial order, seeming to defer to the Postal Service's view that correcting illegal rates might cause the Postal Service to lose some revenue. Of course, even if true, this is no reason to avoid compliance with the Commission's order. This section (and the Appendix) addresses and debunks the Postal Service's theory that it cannot both raise prices for Standard Flats and maximize contribution under a price cap regimen. This section explains the Valpak Standard

---

[10] The Postal Service exigent rate filing in Docket No. R2010-4 gave Periodicals a substantial, above-average increase, but did not do so in Docket No. R2013-11.

Mail contribution maximization model as it was originally presented in Docket No. ACR2012 ("2012 version"), as enhanced in 2013 ("2013 version"), and now as improved and presented in the Appendix to these Initial Comments ("2014 version").

A. History of Valpak Standard Mail Contribution Maximization Model.

1. Appeal of FY 2010 Annual Compliance Determination.

The Commission's finding in its FY 2010 ACD that underwater rates for Standard Flats were not in compliance with Title 39 was challenged by the Postal Service in the U.S. Court of Appeals for the D.C. Circuit. To justify its underwater pricing of Standard Flats, the Postal Service made a new argument in its petitioner's brief that had not been made before the Commission. The Postal Service argued that, under a price cap, giving larger increases to a decreasing volume product (*e.g.,* Standard Flats) and forgoing increases on an increasing volume product (*e.g.,* Standard Letters) could lead to a "decrease [in] the amount of contribution generated by the Standard Mail class of products."[11] Postal Service Brief, USCA-DC No. 11-1117, p. 34. The court considered and wisely rejected this new and unsupported argument, affirming the Commission's determination, and remanding on other grounds. U.S. Postal Service v. Postal Regulatory Commission, 676 F.3d 1105 (D.C. Cir. 2012).[12]

---

[11] The Postal Service, needing to tie its new appellate argument to something in the record before the Commission, landed upon an obscure comment filed by the American Catalog Mailers Association for that purpose.

[12] The Postal Service also stated: "The Postal Service's goal at this time in its history must be to maximize contribution, not reduce it." *Id.*

2. Docket No. R2013-1.

In Docket No. R2013-1, the Postal Service's request included a library reference called a "Standard Mail Contribution Model." *See* Docket No. R2013-1, USPS-LR-2013-1/7. That model compared the effect of price changes in two Standard Mail products (Letters and Flats). (The model was limited to one year — a single price change — and completely ignored price elasticity.) It presented six scenarios seeking to demonstrate that it was possible for the Postal Service to generate more contribution from price increases to Letters than to Flats. *See* Docket No. R2013-1, Postal Service Notice of Market-Dominant Price Adjustment (Oct. 11, 2012), p. 23. The Postal Service also claimed that following the Commission's FY 2010 ACD directive, imposing above-average price increases for Standard Flats, "could also have negative long-term effects on the ability of Standard Mail to contribute to covering network costs." *Id.*, pp. 23-24.

Valpak's Comments in that docket demonstrated serious flaws with the Postal Service's overly simplistic model, even for the limited purpose for which it was offered. *See* Docket No. R2013-1, Valpak Comments (Nov. 1, 2012), pp. 15-41. Valpak mentioned that it "is developing a model from which one could develop optimal prices, and in the future would like to share its workpapers with the Commission or the Postal Service." *Id.*, p. 33, n.34.

The Postal Service's reply comments (Nov. 9, 2012) responded to Valpak's criticisms, claiming that Valpak's analysis held true, but only in the short term. The Postal Service presented new alternative contribution models which purported to show that "when an opportunity to increase the price of Letters is forgone, the ability of Letters to contribute to institutional costs is permanently impaired." *Id.*, p. 3. There again, the Postal Service did not focus on the actual contribution received or lost from the respective products.

The Commission did not find the Postal Service's arguments persuasive, especially when it discovered that, due to a Postal Service error, Standard Flats was receiving a below-average increase contrary to the FY 2010 ACD directive. *See* Order No. 1541, pp. 48-49. The Commission determined that the contribution model the Postal Service presented with its Notice did "not take into account current economic trends which are known to impact volume.... As Valpak and Pitney Bowes correctly note, the Postal Service's failure to use price elasticities leads to erroneous conclusions because it ignores the effect of price changes on volume." *Id.*, p. 40.

3. FY 2012 Annual Compliance Determination.

Shortly thereafter, the Postal Service filed its FY 2012 Annual Compliance Report. The Postal Service presented a broader study prepared by Christensen Associates to support the Postal Service's desire to hold the line on price adjustments for Standard Flats, instead of giving Flats above-average increases as the Commission directed. The Postal Service argued, "Assuming that the systemic decline in Standard Mail Flats volume continues, the rest of Standard Mail will be increasingly called upon to cover a larger portion of network costs." FY 2012 ACR, p. 17. Of course, Standard Flats not only failed to contribute to institutional costs, it diverted money from those institutional costs.

The Christensen Associates study consists of a narrative "Scenario Analysis for Standard Mail Contribution" (Dec. 27, 2012), accompanied by a series of models embodied in spreadsheets. Docket No. ACR2012, USPS-LR-FY12-43. That study discussed the effect of different Standard Mail pricing scenarios on Postal Service contribution under the price cap. Specifically, it addressed problems associated with pricing deeply underwater Standard Flats, when that product's volume is in systemic decline "due to trends in demand that are autonomous or *independent of price changes*." *Id.,* p. 1, n.1. Christensen Associates describes the context of its study, as follows:

> In Docket No. R2013-1, the Postal Service claimed that in the face of **systemically declining volume** for one product [Standard Flats] and relatively **more stable volume** for another product (or group of products) [All Other Standard Mail], applying limited price cap authority to the first product at the necessary expense of the second product (or group of products) **can reduce** overall **contribution**, especially in the long run. [*Id.*, p. 1 (emphasis added).]

Valpak Initial Comments in Docket No. ACR2012 explained the extensive faults with the Christensen Associates model. *See* Docket No. ACR2012, Valpak Initial Comments (Feb. 1, 2013), pp. 59-80. Indeed, that model served only to prove Valpak's argument that larger increases should be given to Standard Flats.

Valpak also submitted with its Initial Comments a pricing model that allows the user to identify those prices which increase the contribution obtainable under a price cap up to the maximum available, if desired. *See id.*, pp. 80-107. Even with the diverging volume trend claimed by the Postal Service, above-average increases for underwater Standard Flats were shown to provide greater contribution.

However, as the Commission noted, "Unlike the Christensen model, the Valpak model does not incorporate estimates of secular volume trends." FY 2012 ACD, p. 113. In the end, the Commission declined to use either the Christensen model or the Valpak model, stating:

"These models rely on assumptions about the own-price elasticity of demand of Standard Mail products. The usefulness of both models would be significantly improved if estimates of own-price elasticity of demand were available by product." *Id.*, p. 116.

4. Docket Nos. R2013-10 and R2013-11.

In response to the Commission's constructive criticism, Valpak revised its contribution maximizing model in the following ways:

1. Users of the model now could adjust the assumed elasticity of each product individually and conduct sensitivity analyses with different elasticities;

2. The model now allows for independent secular trends in volume as optional user inputs (as the Postal Service has suggested for Standard Flats and Letters);

3. If independent secular trends are introduced, the model distinguishes between trend-induced and elasticity-induced changes in volume; and

4. The model now can allow unit costs to be adjusted, and distinguish between nominal and real price adjustments.

Valpak provided the revised model directly to senior Postal Service management involved in pricing in June 2013 so that the Postal Service would have time to be able to use it in upcoming pricing. It was never so used by the Postal Service, however.

Valpak also submitted that revised model with its Initial Comments in the exigent price adjustment case, Docket No. R2013-11 (Nov. 26, 2013).

The Postal Service explained that it did not use the Valpak model because: "The Postal Service views a long-run rather than a short-run approach as important.... Long-run profitability requires considering both the short-run (or more immediate) effect of price changes on volume and how much volume will actually be around in the long run to produce a revenue yield." *See* Docket No. R2013-11, Response of Altaf Taufique to POIR No. 11, Question 8. Thus, the Postal Service criticized the Valpak model on grounds that it is only a single-period model. The Postal Service claims to prefer to adjust prices within an ambiguous long-run context that takes long-run profitability into account. *See* the Appendix for further discussion on this issue.

B. The Valpak Model Has Been Made a Multi-Period Model for Docket No. ACR2013.

1. A Multi-period Model Is Now Available to Evaluate Profitability of Subsidies to Standard Flats.

While the Postal Service explained that it would not want to make "mechanistic application" of a model designed to reduce losses and increase contribution, it actually seems that the Postal Service would prefer the Commission to have no tool whatsoever by which to test the Postal Service's decisions to set prices subjectively. Indeed, the Postal Service would rather the Commission not question the Postal Service's refusal to comply with the Commission's remedial order.

In any event, the Postal Service's objection that the Valpak model is a single-period model is now moot. The Valpak model is now a multi-year model. *See* Appendix.

2. A Multi-Period ROI Model Should Be Used to Evaluate Subsidies.

The Postal Service is not adverse to using return on investment ("ROI") models for other purposes. Before the Postal Service makes a capital investment (*e.g.*, AFSM or FSS machines), it computes the expected ROI using some form of multi-period economic model. An ROI model is an accepted and well understood standard. Future benefits (*e.g.*, income or cost savings) are estimated over as many years as the Postal Service deems appropriate.

In the ROI model, those future benefits are discounted back to the present so as to compare future benefits with the present cost on an apples-to-apples basis. The amount by which future benefits are reduced depends, of course, on the discount rate used. In any market-driven organization that is managed in an economically efficient manner, the ROI model represents not only best practices, but also is a standard operating procedure, as well it should be.[13]

The utility of such a model is not limited to capital investments. Nothing would preclude the Postal Service from using a similar model to evaluate an "investment" via compelled cross-subsidy from profitable Standard Mail products to underwater Standard Flats. Those cross-subsidies represent a not-so-hidden "stamp tax" on profitable Standard Mail. Even though these subsidies do not entail a direct expenditure of Postal Service money, they should be treated with the same degree of care since the money being spent is that of customers that use profitable products.

The Postal Service has never offered any model — single-year, multi-year, static, dynamic, or otherwise — that attempts to quantify the economic justification for continuing to disregard the Commission's remedial order so it can continue its subsidy to Standard Flats. For justification, the Postal Service prefers to rely solely on broad statutory "pricing flexibility" and allusions to its subjective "business judgement." But the Commission now

---

[13] A "limiting case" occurs when the present cost exceeds the sum of all future net returns before being discounted. In this limiting case, even a zero discount rate cannot and will not make the investment appear profitable. Thus, in this limiting case no purpose is served by going through the mathematical exercise of discounting.

should step up to its regulatory responsibilities and demand far more as cumulative losses have mounted with each additional year of negative contribution.

Unless and until the Postal Service produces a better model for review on the record, Valpak recommends that the Commission require the Postal Service to use the standard ROI model to justify its "investments" in those subsidies. This model readily enables the Postal Service, and in fact requires it, to project out for many years — 10, 20, 30 years, or however long it thinks will be required for future profits from Standard Flats to exceed present and future subsidies until cumulative profitability is finally reached.[14] The Postal Service likewise can project, or devise, prices and unit costs in future years to its satisfaction, as required to establish the profitability which it foresees, or at least intimates. Projected volumes can be based on and incorporate whatever assumptions about elasticity the Postal Service cares to postulate — as the response of witness Taufique points out, "for Standard Mail Flats … elasticities are not even estimated separately by the Postal Service."[15] *Id.*

Use of the ROI model to justify the "investment" in subsidizing Standard Flats should help satisfy the standard enunciated in the Postal Service's above-quoted response that "Contribution should be evaluated, and enhanced, in a long-run context." *Id.* Presentment of the ROI model thus quantified — or perhaps some other model that the Postal Service

---

[14] *See* discussion concerning the near-term outlook for Standard Flats costs in Section V, *infra*.

[15] The criticism by witness Taufique here is ambiguous. He clearly attacks the Postal Service's elasticity estimate as unreliable. But is his criticism directed at (i) Valpak for accepting and using the Postal Service's elasticity estimates, or (ii) the Postal Service for failing to require its contractor to provide a separate elasticity estimate for Standard Flats, or (iii) both?

considers equivalent or better — would require that the Postal Service no longer rely on vague, subjective generalities but provide real answers to questions that it continues to avoid answering:

- the extent of future losses it expects to incur on Standard Flats before they become profitable; and
- when and by how much it expects Standard Flats to become profitable (*i.e.*, expected coverage) in successive years after achieving breakeven.

Finally, although there continues to be no near-term profitability in the Postal Service's pricing of Standard Flats, perhaps the Postal Service can find a way to make adjustments within the framework of the ROI model so the near-term projected losses will "necessarily [be] consonant with long-run profitability." *See* Docket No. R2013-11, Response of Altaf Taufique to POIR No. 11, Question 8.

3. Analysis of Projected Average Revenue and Contribution from Standard Flats.

The Postal Service has pledged that for the next two years it plans for the percentage increase in the price of Standard Flats by CPI x 1.05. Thus, if CPI increases by 1.0 percent, the price of flats will increase by 1.05 percent. Although the Postal Service commits to maintain these low price increases for only two more years, this analysis extends this pricing formula through the end of the decade to examine intermediate and longer term implications, which should help satisfy the Postal Service's stated preferences.

As a baseline, we assume that the CPI will increase by 1.5 percent per year. Accordingly, (i) the average unit revenue from Standard Flats increases by 1.575 percent each year,[16] while (ii) unit cost increases at the same rate as the CPI, or by 1.5 percent per year. The results under these assumptions are shown in Table II-1. As can be seen from column 1, average revenue increases slowly, but because the unit cost is so much greater than average revenue, the negative contribution (column 3) also increases slightly, *i.e.*, it does not decline.

Table II-1
Standard Flats, Projected Unit Revenue, Cost Scenario, and Contribution
FY 2014 – 2019
Scenario One

Year	(1) Average Revenue	(2) Attributable Cost	(3) Contribution (Loss)
2014	0.389	0.459	(0.070)
2015	0.395	0.466	(0.071)
2016	0.401	0.473	(0.072)
2017	0.408	0.480	(0.072)
2018	0.414	0.487	(0.073)
2019	0.421	0.494	(0.073)

Another, more optimistic scenario is presented in Table II-2. It retains the assumption regarding average revenue increasing at an additional 5 percent times the rate of inflation, but assumes no further increase in unit cost during the remainder of this decade. In other words, Table II-2 assumes that for the next 6 years, the CPI increases at a compound rate of 1.5 percent per year (or by 9.3 percent after six years), but unit costs do not increase at all. Under

[16] In their efforts to minimize the amount spent on postage, mailers may take a variety of steps to reduce their average cost per piece, *e.g.*, reduce weight by using lighter weight paper, putting fewer pages in each catalog, or reducing trim size. To the extent that mailers adopt any such cost-reducing measures, average unit revenue will increase by less than the amount assumed here even if total volume were to remain unchanged.

this assumption the annual net loss in column 3 is reduced, but nevertheless is still quite negative at the end of FY 2019. This exercise demonstrates that having the price of Standard Flats increase by an additional 5.0 percent times the CPI will not eliminate the net deficit any time within the next six years **unless the average unit cost declines quite materially despite steady, continuing increases in the CPI.**[17]

In order for Standard Flats to achieve a level of future profitability to warrant the current and projected subsidy, the unit cost would need to fall quite substantially, *e.g.*, approaching the unit cost of Carrier Route, $0.187; *see* Table V-2, *infra*. The bleak outlook regarding prospects for further reductions in the unit cost of flats is discussed in Section V.C, *infra*.

Table II-2
Standard Flats, Projected Unit Revenue, Cost, and Contribution
FY 2014 – 2019
Scenario Two

Year	(1) Average Revenue	(2) Attributable Cost	(3) Contribution
2014	0.389	0.459	(0.070)
2015	0.395	0.459	(0.064)
2016	0.401	0.459	(0.058)
2017	0.408	0.459	(0.049)
2018	0.414	0.459	(0.045)
2019	0.421	0.459	(0.038)

[17] The response to ChIR No. 2, Question 2c states that "it is unlikely that the shortfall [*i.e.*, subsidy] will be eliminated by 2016." Hence the annual drain on Postal Service liquidity is assured to continue without interruption, but for further steps that the Commission may take.

These tables demonstrate that absolutely nothing supports witness Taufique's assertion that:

> "[the Postal Service] **believe[s] [Standard Flats] will become profitable** as Postal Service and the mailing community adjust to operational and marketplace realities." [Docket No. R2013-11, quoted in Order No. 1926, p. 161 (emphasis added).]

The unstated "operational and marketplace realities" to which witness Taufique alludes could scarcely be more vague and opaque. The above assertion provides no hint, not even a rough estimate, of when the Postal Service thinks (or hopes) Standard Flats might become even slightly profitable. The probable reason, as can be discerned from Tables II-1 and II-2, is that even minimal profitability appears to be so many years in the future. The Commission never should rely on such unsupported speculation. It should demand a much higher standard, as it does with respect to estimates of elasticity; *see, e.g.*, the "Demand Analysis" submitted to the Commission by the Postal Service on January 22, 2014.

The multi-period ROI model, when used to evaluate capital investments, helps ensure mailers that the Postal Service is following best practices of economical and efficient management. Although the Postal Service may regard the compelled cross-subsidy from mailers like Valpak to Standard Flats as an "investment" that somehow is intended to result in future profitability, nothing indicates that meaningful profits are likely to materialize anytime during this decade.[18] Thus, there appear to be no future profits to discount back to present value — only losses. Until the Postal Service can show otherwise, the multi-period ROI model

[18] Since the Postal Service prefers to evaluate contribution "in a long-run context," nothing prevents it from extending the analysis in Table II-1 or II-2 at least through the decade of the 20's, *i.e.*, until 2030, if not beyond.

indicates no justification or support — none — for pricing Standard Flats below cost and continuing to lose money on that product for the foreseeable future.

The purpose of the ROI model is for rational evaluation of investments. Revenues and prices are inputs to the model, not outputs, *i.e.*, it is not a pricing model. The price cap does not appear in the ROI model. Moreover, in all years when losses are inputs to the ROI model because of underpricing the product under consideration, the ROI model does not take into account profits foregone on those other products whose prices were unnecessarily increased in order to finance the cross-subsidy, *i.e.*, the ROI model does not reflect opportunity costs. The ROI model simply indicates that the subsidy to Standard Flats:

- is and has been a terrible "investment,"
- likewise reflects terrible business judgment, and
- should be terminated forthwith.

4. Summary and Conclusion.

If the Commission were to use the ROI model to evaluate the ongoing subsidy to Standard Flats, the only conclusion is that mailers of profitable products most definitely are not receiving the benefits of best practices of honest, economical, and efficient management. In fact, knowingly "investing" in continued losses going forward would appear to reflect the height of uneconomical and inefficient management — contrary to the intent of PAEA. If such unbusinesslike pricing practices should give rise to Congressional doubts concerning the need to enact cost-reducing initiatives requested by the Postal Service, so be it. Nothing in PAEA, including the universal service requirement, condones:

- the billions of dollars that already have been taken from mailers of profitable products and used to "invest" in such subsidies, or

- the additional billions that are now being taken as a result of the decision in the exigent rate case.

The cross-subsidies which the Postal Service forces some users of Standard Mail to pay are akin a hidden "stamp tax," and ought to be viewed as such by the Commission whenever it approves coverages of less than 100 percent. The intent underlying 39 U.S.C. § 3622(c)(3) was (i) to help maintain a more level playing field among all mailers, while (ii) protecting mailers from having to pay the attributable costs incurred by the Postal Service to provide services to other mailers. Regrettably, however, the Postal Service has misused its pricing flexibility deliberately and repeatedly to set coverages of its favored products sent by favored mailers below 100 percent, thereby highlighting the need for pricing flexibility to operate within the limits of Title 39.

To date, the Commission has allowed "pricing flexibility" to override Title 39 so that under no circumstances can the playing field be considered level, nor can the law be seen to protect mailers from implicit stamp taxes and cross-subsidies to those other mailers which the Postal Service chooses to favor. This cannot continue.

C. The Valpak Single-Period Model Revisited Briefly

1. Postal Service Critique of the 2013 Valpak Model. When asked to identify flaws, weaknesses, or shortcomings in the 2013 Valpak model, the Postal Service's complete response was as follows:

> The Postal Service views a long-run rather than a short-run approach as important. Standard Mail Flats and Standard Mail Letters volumes appear to be on different autonomous

> (independent of price) tracks. Long-run profitability requires considering both the short-run (or more immediate) effect of price changes on volume and how much volume will actually **be around in the long run** to produce a **revenue yield.** The Valpak model fails to account for the permanent impairment of overall **average revenue per piece** that can come from devoting **limited price cap space** to volume that is in comparative autonomous decline. [Docket No. R2013-11, Response of Altaf Taufique to POIR No. 11, Question 8 (emphasis added).]

The Postal Service response focuses exclusively on total revenue — *e.g.*, revenue yield and average revenue per piece. Contribution is not mentioned.[19] Profitability seems to be of little or no importance to the Postal Service's key pricing witness, which perhaps explains why there was a liquidity crisis in FY 2013.[20] The Valpak model, by contrast, is concerned with contribution, *i.e.*, profitability. A misguided focus on gross revenue instead of net revenue is a sure road to ruin.[21]

The Postal Service seems to desire to make sure that this year's money-losing volume will "be around in the long run," generating a future revenue yield that, whenever the long run finally arrives, is almost certain also to be below cost. **This strategy amounts to losing money now so that the Postal Service can be assured of having volume on which it can**

---

[19] *Compare* with statement in the Postal Service's brief in the appeal of the FY 2010 ACD: "The Postal Service's goal at this time in its history must be to maximize contribution, not reduce it."

[20] The exclusive concern with revenue, as opposed to contribution, could go back to the time when the Postal Service had excess employees who had to be retained on the payroll regardless of whether there was any work for them to do, and whatever money was expended would be extracted from mailers. PAEA was supposed to change all that, but as the recent exigent case demonstrates — not so much.

[21] It is reminiscent of the apocryphal merchant who knew he lost a little on each item, hoping to make it up on the volume.

continue losing money in the long run. It is tantamount to a plan to maximize both short-run and long-run losses, undermine liquidity in perpetuity, and lay the foundation for yet another exigent rate case. If there were such a thing as economic malpractice, a strategy such as that would qualify. The Postal Service should cease proffering, and the Commission should cease accepting, such lame excuses for uneconomical and inefficient pricing decisions that are consistent only with "worst practices."

2. The Standard Flats Product Is Deeply Underwater.

Any model that purports to acknowledge the existing reality must include the fact that Standard Flats are deeply underwater, as does the Valpak model. Otherwise, the model would be in denial of current reality. Unit profitability of Standard Flats could be achieved either by (i) increasing price, or (ii) by a substantial reduction in unit cost, which is something the Postal Service has not been and will not be able to achieve. *See* Section V, *infra.* Until unit profitability is achieved, the inescapable conclusion is that a reduction in money-losing volume is the best way for the Postal Service to increase its aggregate contribution and liquidity. A decline in underwater Standard Flats volume accompanied by **reduced losses** (*i.e.*, by an **increase in contribution and liquidity**) is of course what actually occurred during the 2007-2009 recession, as MPA, *et. al.*, recognized in their comments in the exigent rate case. It is not just a conclusion derived from some abstract model.

3. Estimated Elasticity.[22]

As noted in the Section A, *supra*, witness Taufique disparaged (i) the Postal Service's elasticity estimate as unreliable because it applies to both Flats and Letters,[23] and (ii) Valpak's 2013 model for using those "unreliable" Postal Service estimates. What he failed to discuss is the fact that the Valpak model is deliberately constructed to enable the conduct of sensitivity analysis in which assumed elasticities can be changed at will. In such an analysis, the value of elasticity as estimated by the Postal Service becomes a moot issue. The Postal Service's "joint" estimate of elasticity is just one of many possible points within a wide range. Section III of the Appendix to Valpak's Initial Comments in Docket No. R2013-11 provided an example of such a sensitivity analysis in the context of a single period. That analysis showed that when elasticity is assumed to vary over a quite wide range, the fundamental conclusion concerning desirability of using "limited cap space" to increase the price of Standard Flats does not change. The salient points here are:

i. Standard Flats do have some elasticity of demand;

ii. using "limited cap space" to raise the price will increase coverage and reduce the volume of Standard Flats;

iii. the price of Standard Flats needs to be increased and volume reduced at least until coverage reaches 100 percent, at which time there will be no more aggregate losses from Flats;

iv. the quicker this adjustment occurs, the more Postal Service profits and liquidity will benefit — *i.e.*, this result represents the

---

[22] Since elasticity refers to changes in the "real" price, the elasticity effect of CPI-only increases would be minimal.

[23] It also applies to Standard Parcels, but their volume is now inconsequential.

highest and best use of the Postal Service's "limited cap space;" and

v. the more elastic is demand, the less the price increase necessary to achieve any given reduction in volume and aggregate losses.

Witness Taufique criticizes the Postal Service for its failure to develop a separate elasticity estimate for Standard Flats, implying that elasticity may be somewhat higher than the "joint" estimate. Sensitivity analysis enabled by Valpak's model allows easy investigation of this possible scenario. But there is another, much simpler, way to analyze the assertion that Standard Flats may have an elasticity of demand that is higher than the "joint" estimate. That assertion has not only important implications, but also certain misunderstandings, which the Postal Service needs to comprehend. Detailed models with numerical outputs are not necessary, as a simple analysis should suffice.

Start with the simple assumption that, above the existing price, the demand for Standard Flats is **perfectly elastic**. It cannot get any higher than that (in absolute value). This means that for any real price increase above the existing price, the demand would be zero. Since Standard Flats are underwater and the existing price is well below current cost, the assumption of perfect elasticity also means there is **no price at which the Postal Service ever could earn a profit** on any of the existing Standard Flats volume **because the entire volume would disappear from the mail long before price could reach a level at which the Postal Service might earn even a small profit.** The assumption of perfect elasticity, although not realistic, is both illustrative and insightful.

Next, assume Standard Flats have a high elasticity, much greater than the "joint" estimate, as witness Taufique (and others) imply.[24] The implications, although not identical to those with perfect elasticity, are somewhat similar. Namely, with very high elasticity, **a quite substantial portion of the current volume** of Standard Flats would disappear **well before price ever could rise to a level at which the Postal Service might earn even a small profit from that volume**. For all those Standard Flats that cannot and will not ever pay a price that exceeds cost, and that perennially require a subsidy to continue using the mail,[25] one result of a higher price would be "permanent impairment" of the subsidy for future losses which those Standard Flats otherwise would require. Standard Flats that cannot and will not ever pay a price that exceeds attributable cost can be said to be **permanently underwater**. All postal products have an elasticity of demand, and hence all price increases impair volume. Instead of using limited cap space to impair the volume of the Postal Service's most profitable products, that cap space could and should be used to achieve the commendable result of increasing the price for those **permanently underwater** Standard Flats. Unless the Postal Service does not care about profitability or liquidity, the pertinent question is: Why the concern with "how much **[permanently underwater]** volume will actually be around in the long run?"[26]

---

[24] This assumption is a hypothetical. Valpak is not asserting that the elasticity of demand for Standard Flats is any higher than that calculated by the Postal Service. In the recent demand analysis submitted on January 22, 2014, the estimate for the "joint" elasticity of Letters and Flats is -0.457163. A "much higher"(in absolute value) elasticity might be -1.50.

[25] The subsidy is akin to a "bribe" which the Postal Service pays to induce Standard Flats to continue using the mail.

[26] The Postal Service made a substantial investment in a fleet of 100 FSS machines. That investment is now a sunk cost. A substantial decline in Standard Flats volume

Finally, in the unlikely event that witness Taufique intended to imply that the demand for Standard Flats is more **inelastic** than the "joint" estimate, then he needs to face the question: Why is the price increase on underwater Standard Flats being restrained to the point of damaging the Postal Service's liquidity?

4. Autonomous Trends.

The Postal Service likewise fails to mention that the Valpak model is deliberately constructed to enable the conduct of sensitivity analyses with respect to autonomous volume trends such as those mentioned in its critique cite above. Section IV of the Appendix to Valpak's Initial Comments in Docket No. R2013-11 provided an example of such a sensitivity analysis in the context of a single period. That analysis demonstrates that if Standard Flats indeed are in an autonomous secular decline in the range experienced to date, the fundamental conclusion concerning desirability of using "limited cap space" to increase the price of Standard Flats does not change one iota. The aggregate loss from Standard Flats is still much too high, and should be reduced promptly.[27] The Postal Service's limited cap space needs to be utilized to curtail this loss, instead of using that cap space to curtail the volume of its most profitable products.

---

could make the Postal Service executives who made that capital investment decision appear to have made a mistake, but from an economic perspective embarrassment would not be an appropriate reason to choose to continue losing money on Standard Flats.

[27] The enhanced cash flow from the exigent rate increase is no reason to delay. The Postal Service has postponed investment to maintain its fixed capital, and its balance sheet has liabilities that exceed assets by $39.8 billion at the end of FY 2013, with off-balance sheet liabilities equally large. 2013 Form 10-K, p. 22.

5. Summary and Conclusion.

Valpak's 2013 one-period contribution maximizing model, as well as common economic sense, demonstrated conclusively that the Postal Service's supposed long-term approach to Standard Flats pricing is faulty. Instead of using its limited cap space to impair the volume of its most profitable products, the Postal Service should focus on contribution and liquidity — not revenue — and use its cap space to (i) curtail losses on underwater products, and (ii) avoid, or at least postpone, another liquidity crisis.[28]

D. The Valpak 2014 Multi-Period Model for Enhancing Contribution

In response to criticism in Docket No. R2013-11, the Valpak single-period model now has been expanded to include an additional period. The model shows how to increase contribution systematically, up to the maximum available under the cap, if desired. A more detailed discussion of this two-period model can be found in the Appendix to these comments, along with instructions on possible expansion to more periods, if desired.

1. Highlights of the Expanded 2014 Valpak Model.

Expanding the model to accommodate additional time periods does not alter the fundamental way by which pricing can increase contribution. That fundamental way, of course, is the time-honored principle of encouraging the company's profitable product "winners" while cutting back on and eliminating the unprofitable product "losers." It may not be rocket science, but it works.

---

[28] "The Postal Service's goal at this time in its history must be to maximize contribution, not reduce it." *See* p. 12, *supra*.

Under current law, the price cap applies to each class of mail. Each year the price cap limits the total revenue that can be obtained from all products within each class. And each year, this limitation on revenue forces tradeoffs, both in the real world and in the model. Namely, when price adjustments collectively increase revenue to the maximum permitted by the price cap, any further increase in the price of one product necessitates an offsetting reduction in the price of one or more other products so as not to exceed the cap.[29] Offsetting price adjustments that just maintain the maximum revenue allowed by the cap have differential effects on contribution and are defined here as "**tradeoffs**." The idea underlying tradeoffs is to focus price increases on those products where they will have the greatest impact on contribution[30] and liquidity, *i.e.*, the Postal Service's bottom line.

2. Summary and Conclusion.

The Postal Service adjusts prices in a manner designed to utilize virtually all of the available cap space. That is, it maximizes available revenue. Contribution is another matter, however. Different price increases that produce the same total revenue can result in quite different contributions. The Postal Service's price adjustments almost invariably leave substantial room for increasing the net contribution and liquidity — *i.e.*, in each annual price adjustment exercise it can be said that the Postal Service deliberately and knowingly leaves a large amount of contribution, or net liquidity, on the table. The Postal Service professes to be

---

29 With respect to **revenue**, the price cap can be viewed as a "zero-sum game." For **contribution**, however, this is not true. *See* Appendix, Section III.

30 "The Postal Service's goal at this time in its history must be to maximize contribution, not reduce it." *See* p. 12, *supra*.

fully aware of the tradeoffs involved. To justify the shortfall in net cash flow caused by continuing to run substantial deficits on those products that are perennially underwater, it proffers a variety of rhetorical explanations (usually intangible, judgmental, and non-quantitative).[31]

By using the tradeoff schedules contained in and generated by the model, the Postal Service readily can see what pricing adjustments will improve its contribution. The model can be used to improve contribution systematically (not mechanistically), and maximize contribution if desired, but moving all the way to the point of maximum profits is not necessary. It certainly would help to replace what is now highly speculative, biased pricing with more objective pricing.

Having enhanced the single-period model to a multi-period model, it is seen that conclusions drawn from the single-period model by Valpak remain true. Postal Service contribution can be increased, up to the maximum available under the price cap, by bringing the price of Standard Flats up so as to cover its costs as soon as possible. The reasons advanced by the Postal Service for disregarding and frustrating the Commission's remedial order for pricing of Standard Flats have been demonstrated to be bogus, and the Commission must now require it be carried out fully and without further delay.

---

[31] The Postal Service argues that "the mere tolerance of underwater products … does not, in and of itself, demonstrate a failure to exercise honest, efficient, and economical management, in light of the various other factors for which management's **reasoned business judgment** must account." Order No. 1926, p. 137 (emphasis added). Of course, that tolerance for losses on underwater products does contribute to a liquidity shortfall each year, which in large part gave rise to the need for an exigent rate case to begin with.

III. Numerous Underwater Products Continue to Plague the Postal Service, Causing Losses that Triggered an Exigent Rate Increase, Further Harming Profitable Products such as High-Density/Saturation Letters.

A. In FY 2013, the Postal Service Lost over $1 Billion on Eight Products.

The Postal Service's losses on eight market dominant mailing products totaled **$1.113 billion** in FY 2013. This is some improvement from the enormous $1.461 billion loss sustained in FY 2012, attributable largely to reduced volume. *See* Table III-1, *infra*. Of these eight products, the largest losses continue to be from Standard Flats and Periodicals Outside County.[32] Losses from these two products alone ($886 million) constitute 80 percent of the $1.113 billion of eight underwater product losses.

Putting these losses into context, without the loss from these eight products, the **Postal Service's FY 2013 operating profit** would have been $1.736 billion (*see* p. 11, *supra*) or about equal to the additional contribution the Postal Service will earn from the first year of the exigent rate case ($1.78 billion).

---

32 The entire Periodicals class remains underwater at 76.1 percent cost coverage.

Table III-1
Loss-Generating Market Dominant Products, FY 2012-2013
(Exclusive of Special Services)

Product	FY 2012 Deficit (million)	FY 2012 Coverage	FY 2013 Deficit (million)	FY 2013 Coverage
First-Class Parcels	$10	98.4%	$17	97.2%
Inbound Int. Single-Piece First-Class Mail	$66	65.8%	$78	65.6%
Standard Mail Flats	$532	80.7%	$380	84.9%
Standard Mail Parcels	$53	84.3%	$39	64.3%
Periodicals Within County	$29	69.7%	$22	75.2%
Periodicals Outside County	$649	71.8%	$506	75.8%
Single-Piece Parcel Post	$66	92.1%	$13	96.1%
Media and Library Mail	$56	85.1%	$58	84.2%
Total	**$1,461**		**$1,113**	

Sources: FY 2012 ACR, Tables 1-4; FY 2013 ACR, Tables 1-2, 4-5.

In the exigent case, the Commission believed the Postal Service's **liquidity crisis** necessitated the exigent price adjustment based on the 2007-2009 recession: "To make the showing [that the exigent request is necessary], Nickerson offered an extensive discussion of the Postal Service's liquidity crisis to illustrate 'why [the additional contribution requested by the Postal Service] is necessary to ensure that the Postal Service continues to provide prompt, effective, and reliable universal postal services.'" Docket No. R2013-11, Order No. 1926,

p. 44. The Commission concluded, "The Postal Service's **overall financial condition** is relevant to the Commission's analysis because an exigent rate adjustment would not be necessary if the Postal Service had the ability to maintain and continue the development of the Nation's needed postal services independent of an exigent rate adjustment." *Id.*, p. 116 (emphasis added). And the Postal Service admits that its liquidity is tied directly to contribution or losses from individual products. *See* Docket No. R2013-11, Response of Stephen J. Nickerson to POIR No. 10, Question 1. Thus, underwater products are jeopardizing "the ability to maintain and continue the development of the Nation's needed postal services." Order No. 1926, p. 44 (referring to 39 U.S.C. § 3622(d)(1)(E)).

Since the 2007-2009 recession began, the losses on underpriced products during and since the 2007-2009 recession ($8.646 billion) dwarf the total contribution the Commission determined the Postal Service was allowed to recover from the exigent rate case, *i.e.*, $2.766 billion. *See* Order No. 1926, p. 106.

Table III-2
Loss-Generating Market Dominant Products, FY 2008-2013
(Exclusive of Special Services)

Product	FY '08 Deficit (million)	FY '09 Deficit (million)	FY '10 Deficit (million)	FY '11 Deficit (million)	FY '12 Deficit (million)	FY '13 Deficit (million)	Total (million)
First-Class Parcels	—	—	$1	—	$10	$17	$28
Inbound Int. Single-Piece First-Class Mail	$53	$105	$53	$36	$66	$78	$391

Standard Mail Flats	$228	$622	$582	$652	$532	$380	$2,996
Standard Mail NFMs and Parcels	$167	$208	$178	$117	$53	$39	$762
Periodicals Within County	$5	$15	$25	$20	$29	$22	$116
Periodicals Outside County	$450	$643	$598	$597	$649	$506	$3,443
Single-Piece Parcel Post	$66	$62	$134	$89	$66	$13	$430
Bound Printed Matter Parcels	—	$9	$28	$5	—	—	$42
Media and Library Mail	$60	$75	$90	$99	$56	$58	$438
Total	**$1,029**	**$1,739**	**$1,689**	**$1,615**	**$1,461**	**$1,113**	**$8,646**

Sources: FY 2008-2013 ACRs.

B. The Postal Service's Inconsistent Positions.

Although the Postal Service has no problem imposing cross-subsidies on mailers like Valpak, it chafes under the cross-subsidies imposed on it:

> we continue to seek a refund of the overfunding of FERS as those funds would help alleviate some of our short-term liquidity risks. OPM projected that the FERS overfunding was $0.5 billion at September 30, 2013, the latest actual data available. However, the OIG has determined that **if Postal Service specific assumptions** were used to estimate the FERS obligation, **rather than the government-wide averages** currently used, the surplus would be substantially greater than the amount calculated by OPM. [2013 Form 10-K, p. 48 (emphasis added).]

In essence, the Postal Service sees itself as cross-subsidizing the retirement costs of nonpostal government employees, it believes such cross-subsidization is unfair and unjust, and it would like such cross-subsidization to be terminated forthwith. However, the Postal Service has no problem with forcing some of its customers to cross-subsidize others. It apparently does not feel that it is unfair or unjust for one set of mailers to pay both the losses and institutional costs for both that set of mailers and for another set of mailers.

Additionally, in its discussion on capital investments, the FY 2013 Form 10-K states that:

> Given the current financial and liquidity challenges facing the Postal Service, management implemented a capital commitment plan which was below average historical levels. Capital spending limitations, first initiated in 2009 to conserve cash continued throughout the year. Priority was given to projects: 1) needed for safety and/or health or legal requirements; 2) required to provide service to our customers; and 3) **initiatives with a high return on investment and a short payback period.** [*Id.*, p. 10 (emphasis added).]

The preceding statement must apply only to investments funded by the Postal Service's own cash. Because when the Postal Service chooses to sustain losses on underwater products such as Standard Flats, in the hope of a better tomorrow, it asserts that a "short payback period" would be totally inappropriate. The Postal Service insists on a quantitative estimate of the return on hardware investments, such as FSS. However, massive cross-subsidies of underwater products require no estimate whatsoever of the ROI, much less an ROI that exceeds any standard or threshold. Such practices not only are totally inconsistent with honest, efficient, and economical management, but also can contribute materially to the downward spiral in which the Postal Service appears locked.

C. The Price Cap Provides No Protection against Irrational Pricing.

The Commission has asserted in the past that the price cap will shield mailers from Postal Service pricing practices.

- "Market dominant mailers also have the additional **protection** of a price cap to shield them from **excessive pricing**." FY 2011 ACD, p. 97 (emphasis added).
- "Market dominant mailers have the **protection** of a price cap to shield them from **excessive price increases**." FY 2012 ACD, p. 82 (emphasis added).

Of course, the price cap does not apply in exigent rate cases. The Commission recently approved prices above the price cap in Docket No. R2013-11. The 4.3 percent across-the-board increase in the exigent case was made necessary, in large part, from losses sustained from underwater products. The price cap provided no protection for mailers. Failure to price products in a rational, fair, and equitable manner eventually hurts all mailers, especially profitable mailers, as demonstrated by the excessive increases in the exigent rate case. The Commission's continued approval of ongoing losses on underwater products totally undermines whatever "protection" the price cap was supposed to afford mailers.

D. Comparison with Other Standard Mail Products Shows less than Meaningful Improvement in Standard Flats.

The Postal Service's discussion of Standard Mail products shows Standard Flats' cost coverage increasing from 80.7 percent in FY 2012 to 84.9 percent in FY 2013. The Postal Service also discusses changes in coverage of the other underwater product, Standard Parcels, but omits discussion of other Standard Mail products. Comparing all of the Standard Mail products shows that the **4.0 percent** coverage improvement achieved by Standard Flats is small compared to the coverage increase of profitable products: HD/Sat Letters, HD/Sat Flats &

Parcels, and Standard Letters, each which increased by **over 10 percent**. It is no wonder the Postal Service did not set out coverages of all products, because it would have demonstrated that already abusively high rates for saturation mail has gotten even worse. Indeed, the coverage spread between High-Density/Saturation Letters and Standard Flats increased in FY 2013 from 141.3 percent to 150.9 percent.

Table III-3
Standard Mail Products
FY 2012-FY 2013 Cost Coverage

	FY 2012 Cost Coverage	FY 2013 Cost Coverage	Change
HD/Sat Letters	**222.2%**	**235.8%**	13.6%
HD/Sat Flats & Parcels	217.3%	229.0%	11.7%
Carrier Route	130.8%	133.4%	2.6%
Letters	178.9%	189.0%	10.1%
Flats	**80.9%**	**84.9%**	4.0%
Parcels	85.5%	64.3%	-21.2%
EDDM-R	N/A	359.9%	N/A

Also, while it is good that Standard Flats costs decreased by 2.8 percent, High-Density/Saturation Letters costs decreased even more rapidly, by 3.8 percent.

Table III-4
Standard Mail Products
FY 2012-FY 2013 Unit Costs

	FY 2012 Unit Costs	FY 2013 Unit Costs	Change	Percentage Change
HD/Sat Letters	6.24	6.0	-0.24	-3.8%

HD/Sat Flats & Parcels	7.65	7.4	-0.25	-3.3%
Carrier Route	18.87	18.7	-0.17	-0.9%
Letters	10.93	10.5	-0.43	-3.9%
Flats	46.5	45.2	-1.3	-2.8%
Parcels	111.3	151.3	+40	35.9%
EDDM-R	N/A	3.9	N/A	N/A

E. Title 39 And Underwater Products.

The existence of deeply underwater Standard Flats and other underwater products continues to violate Title 39, as the Commission should expressly find.

(A) Because some products pay an unconscionably high cost coverage while other products do not cover their costs, the Postal Service has failed "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). The Postal Service has perpetuated the inequity with its pricing in Docket Nos. R2013-10 and R2013-11, especially with its across-the-board exigent price increase.

(B) The Postal Service has engaged in "undue or unreasonable discrimination" among mailers by overcharging some mailers to force cross-subsidization of others. 39 U.S.C. § 403(c). This is an inappropriate and illegal use of its pricing flexibility.

(C) Postal rates and fees have not been equitable, and on balance have not been sufficient "to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States." 39 U.S.C. § 404(b). As explained above, postal prices are inequitable because of the perpetuation of cross-subsidization. Furthermore, they have failed to maintain the Postal Service in a manner that it can continue without the need for a transfusion of cash through the exigent pricing mechanism.

(D) The Postal Service has failed to send proper pricing signals by discouraging higher cost products and encouraging lower cost products in violation of the pricing objective of "maximiz[ing] incentives to reduce costs and increase efficiencies." 39 U.S.C. § 3622(b)(1).

(E) The failure to price properly has resulted in an exigent price adjustment being "necessary" because of the lack of liquidity. The exigent price adjustment violates the objective of "predictability and stability in rates." 39 U.S.C. § 3622(b)(2).

(F) Prices have failed to "assure adequate revenues … to maintain financial stability," as further evidenced by the necessity of the exigent price adjustment. 39 U.S.C. § 3622(b)(5).

(G) Three pricing Factors in 39 U.S.C. § 3622 have suffered as a result of the Postal Service's pricing decision, including failure to meet the "requirement that each class of mail or type of mail service bear" its attributable costs — (c)(2); "pricing flexibility" not for the sake of itself, but "to encourage increased mail volume and operational efficiency" — (c)(7); and "the need for the Postal Service to increase its efficiency and reduce its costs … to help maintain high quality, **affordable** postal services" — (c)(12) (emphasis added).

The Postal Service's exigent price adjustment is an indictment of itself in that it has failed to follow good business practices and reasonable, much less intelligent, pricing of its products. Certainly the recession caused volume loss, but the Postal Service could have weathered that loss without an exigent rate increase it if it had priced products lawfully, and cut costs aggressively (*see* Section VI, *infra*).

IV. Postal Service Pricing of Standard Flats Continues to Be Out of Compliance with PAEA, Demanding a New, Meaningful Remedy that Resolves the Inequity.

Over the last three years, the Postal Service has alternately challenged, defied, ignored, and minimally complied with the Commission remedial order to adjust prices for Standard Flats until prices exceed costs originally entered in Docket ACR 2010 — and the Commission has responded with remarkable forbearance — which should end with this docket.

A. Docket No. ACR2010.

In its FY 2010 ACD, the Commission found that the Postal Service's pricing of Standard Flats violated 39 U.S.C. section 101(d). FY 2010 ACD (Mar. 20, 2011), p. 106. It determined that the compelled cross-subsidization of Standard Flats by other products "reflects an unfair and inequitable apportionment of the costs of postal operations to all Standard Mail users.... [and that t]he Postal Service has failed to utilize the pricing flexibility granted to it by the PAEA to address this issue...." *Id.* Thus, the Commission ruled that other Standard Mail users, including Valpak, were charged too much, while Standard Flats users were charged too little.

Based on its finding of a statutory violation, the Commission then directed the Postal Service to take four remedial actions:

> 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**.
>
> * * *
>
> 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....
>
> * * *

> 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, pp. 106-07 (emphasis added).]

The Postal Service appealed the Commission's finding and order, filing a Petition for Review. On April 17, 2012, the U.S. Court of Appeals for the D.C. Circuit upheld the Commission's finding and remedial order, only remanding to the Commission for "definition of the circumstances that trigger § 101(d)'s failsafe protection, and for an explanation of why the particular remedy imposed here is appropriate to ameliorate that extremity." U.S. Postal Service v. Postal Regulatory Commission, 676 F.3 1105 (D.C. Cir. 2012). On remand, the Commission affirmed its remedial order and provided the explanation required by the court. *See* Order No. 1427. Following that, in Order No. 1472, the Commission confirmed the termination of a partial stay,[33] and ordered the Postal Service to provide the information

---

[33] During the pendency of the appeal, the Commission had stayed a portion of its order: the requirement that the Postal Service provide a schedule of above-CPI price increases. *See* Order No. 739.

required by the FY 2010 ACD as well as to provide the schedule of above-CPI price increases with its FY 2012 ACR.

B. Docket No. R2012-3.

In its Notice of Market Dominant Price Adjustment in Docket No. R2012-3 (Oct. 18, 2011), the Postal Service purported to comply with the FY 2010 ACD by giving Standard Flats an above-CPI price increase, but offered only bare technical compliance: the increase for Flats was **0.076** percentage points above the price cap (*i.e.*, CPI x 1.035). The Commission allowed this minimalist compliance in part because of the pendency of the appeal of the FY 2010 ACD and in part because the "Postal Service technically complied with the Commission's directive." Order No. 987, p. 32.

Additionally, the Postal Service failed to file the information that the Commission required in its FY 2010 ACD order applicable to subsequent notices of market dominant price adjustments. Valpak pointed this out in its comments (Valpak Comments, pp. 12-13 (Nov. 7, 2011)), but the Commission largely ignored the failure, merely stating that it was "concerned with the lack of explanation provided by the Postal Service as directed in the FY 2010 ACD." Order No. 987, p. 32. The Commission also stated that it "expects the Postal Service to file an explanation of how price increases and cost reductions are being used to reduce the intra-class cross-subsidy and to improve the cost coverage for Standard Flats in the next Annual Compliance Report." *Id.*, p. 4.

C. Docket No. ACR2011.

The Postal Service deliberately disregarded the Commission's FY 2010 ACD remedial order by not filing any of the required information with its FY 2011 ACR. ChIR No. 1, Question 9 (Jan. 19, 2012) requested the information that the Postal Service should have filed with both the FY 2011 ACR and the Docket No. R2012-3 Notice of Market Dominant Price Adjustment.

In the FY 2011 ACD, the Commission once again found Standard Flats to be out of compliance, but did not order additional remedial action because the appeal of the FY 2010 ACD was still pending. *See* FY 2011 ACD, p. 119.

D. Docket No. R2013-1.

In the next pricing adjustment, once again, the Postal Service deliberately disregarded the Commission's remedial order, requiring the Commission to request the required information. *See* CIR No. 1, Question 1. The Postal Service's Notice also deliberately disregarded the remedial order requirement to provide **above-cap** price adjustments for Standard Flats, instead purporting to give an **at-cap** price adjustment. Certain recalculations revealed that the Postal Service's proposed increase for Standard Flats was actually **below the cap**, and the Commission rejected and remanded the prices. On remand, the Postal Service provided a tiny increase to Standard Flats amounting to CPI x 1.018. Nevertheless, the Commission approved the prices on remand, stating, "Although Valpak and the Public Representative take issue with the amount of the price increase, the Commission concludes that these rates comply with the FY 2010 ACD directives." Order No. 1573, p. 5. The only sense in which they could have been said to comply was that they were technically, barely, above average, demonstrating the Postal Service had no realistic goal of ever having Standard Mail Flats cover their costs.

E. Docket No. ACR2012.

In last year's ACR, the Postal Service again deliberately disregarded the FY 2010 ACD remedial order. Indeed, it has become a matter of routine that one of the Commission's first actions after the Postal Service's filing of an ACR is issuance of an information request (again) asking the Postal Service to provide the information required by the FY 2010 ACD remedial order. The Commission issued ChIR No. 1, Question 2 (Jan. 4, 2013). Further questions about Standard Flats were asked by the Commission on Valpak's motion. ChIR No. 4, Questions 1-4. In that request, the Commission noted only that "In its FY 2012 ACR filing, the Postal Service was not responsive to the Commission's FY 2010 ACD directive." FY 2012 ACD, p. 111.

In its determination, the Commission looked at the totality of circumstances presented in FY 2012 — as it described in its Order on Remand, Order No. 1427 — and determined that:

> the steps taken thus far [by the Postal Service] have been helpful but it is **concerned** that the Postal Service has not quantified the cost savings from operational changes designed to reduce Flats costs. Consequently, the Commission **cannot properly assess**[34] the likely rate of improvement in the cost coverage shortfall. [FY 2012 ACD, p. 116 (emphasis added).]

The Commission observed that, because "the Postal Service has **begun to make progress** towards addressing the issues raised by the Commission in the FY 2010 ACD," no changes were required "to the Commission's FY 2010 ACD directive." *Id.* (emphasis added).

---

[34] Of course, there is no way for the Commission to confirm or analyze "anticipated cost savings" because the Postal Service never provides any information.

Unlike the FY 2010 ACD and the FY 2011 ACD, the Commission did not appear to make an express finding of noncompliance in the FY 2012 ACD. However, given the fact that it maintained the remedial directives of the FY 2010 ACD, the Commission's comments were consistent with an implicit finding that Standard Mail Flats once again were not in compliance during FY 2012, or at least that the FY 2010 ACD finding and order were still in effect.

F. Docket Nos. R2013-10 and R2013-11.

Maintaining its deliberate defiance of the Commission's authority, the Postal Service did not submit the information required by the Commission's remedial order in FY 2010 ACD in either Docket No. R2013-10 (annual CPI adjustment) or Docket No. R2013-11 (exigent price adjustment). In both cases, the Commission had to issue information requests in order to have the Postal Service submit the required information. *See* Docket No. R2013-10, Postal Service response to ChIR No. 3, Question 6; Docket No. R2013-11, Postal Service response to POIR No. 2, Question 9.

In both cases, the Postal Service represented that "anticipated cost savings" would increase Standard Mail Flats cost coverage to 87 percent for FY 2013. Of course, now we know that this "estimate" was in error — fully 2 percentage points higher than the actual coverage.[35] It was based on that erroneous estimate that the Commission approved Postal Service pricing.

The price increase in Docket No. R2013-10 for Flats was slightly above the cap, and even above CPI x 1.05, at CPI x 1.067. However, in Docket No. R2013-11, the Postal

[35] It is hoped that perhaps the Commission will bear this point in mind next time the Postal Service claims unsupported cost savings.

Service deemed an across-the-board approach to be a fair dispersal of the burden of the liquidity crisis (such crisis having been caused in no small part by high tolerance for underwater products on the part of the Postal Service and the Commission) and the increase for Standard Mail Flats was under the Postal Service's self-imposed mark — Standard Mail average x 1.004. Nevertheless, the Commission approved the Postal Service price increase.

G. Docket No. ACR2013 — the Current Docket.

The Postal Service at long last did something to comply with the Commission's FY 2010 ACD directive in this docket, but only in part. The Postal Service provided one aspect of the information required, *i.e.*, the update to the schedule of above-average price increases. *See* FY 2013 ACR, p. 19. However, the Postal Service still refused to provide the required information related to (i) operational changes, (ii) costing methodology improvements, and (iii) the historical and estimated timeline for phasing out the subsidization of Standard Mail Flats. The Commission, once again, was forced to ask the Postal Service for this information in a Chairman's Information Request. *See* ChIR No. 2, Question 1.

H. Effect of Continued Noncompliance.

Now, six full years into PAEA,[36] the Postal Service has lost a total of $3 billion on that one product, Standard Mail Flats. The Postal Service cannot or will not predict when, if ever, that product will cover its attributable costs. The Postal Service is still willing to predict only: "While the Postal Service has committed to increasing Standard Mail Flats prices by at least CPI x 1.05 during the next two market-dominant price changes, it is unlikely that the shortfall

---

[36] And it has been six years that the Postal Service has been reporting separate data with respect to the Standard Mail products.

will be eliminated by the end of 2016…." Postal Service response to ChIR No. 2, Question 1.c. "Unlikely" is an understatement of epic proportions. *See* Tables II-1 and II-2, *supra*.

It is indisputable that the Postal Service has defied the Commission's remedial pricing order and the reporting requirements in the FY 2010 ACD — and it has gotten away with it. The Postal Service has demonstrated a pattern of deliberate noncompliance which the Commission can continue to ignore only at the peril of materially weakening the Commission's statutory authority and causing Congress to doubt that the entire postal regulatory system is working. *See*, *e.g.*, plans to eliminate Commission pricing authority in 113th Cong., S. 1486, Section 301.

The Commission should, but has been unwilling to, use the range of statutory enforcement powers given it under PAEA, including the power to order fines in cases of deliberate noncompliance (39 U.S.C. § 3662(d)) and the ability to seek relief from the federal district courts to enjoin the Postal Service from violating orders (39 U.S.C. § 3664).

In this docket, the Postal Service has shown that with respect to Standard Mail Flats: (i) the Postal Service has again suffered huge losses ($380 million); (ii) while the product had an improvement in its cost coverage to 84.9 percent, it was not as much as the Postal Service claimed in the recent pricing dockets only a couple of months ago and the gap between its coverage and that of High-Density/Saturation Letters grew to over **150** percentage points; (iii) unit costs were reduced slightly, but at a lower rate than three other Standard Mail products; and (iv) the clear pattern of deliberate disregard for the Commission's directives has continued. These are in addition to the other factors identified in the FY 2010 ACD that continue through FY 2013.[37]

In the past, the Postal Service has argued that it cannot increase Standard Flats prices without losing money due to the price cap. This last of the Postal Service's excuses for not increasing Standard Mail Flats' prices to a compensatory level has now been disproved by the Valpak contribution maximization model filed herein. *See* Section II, *infra*, and Appendix.

The reasons for finding noncompliance in FY 2010 and FY 2011, and for maintaining the remedial directive through the FY 2012 ACD, are again present in FY 2013. The Commission should find that Standard Flats remain out of compliance, and strengthen the FY 2010 ACD directive to make it an effective remedy requiring higher Standard Flats rates that cannot be circumvented.

I. The Need for a Stronger Remedial Directive.

It has been nearly four years now since the Commission found noncompliance with PAEA and issued its remedial order to implement its decision to end the cross-subsidization of Standard Flats by other products that "reflects an unfair and inequitable apportionment of the

---

[37] When the Commission first found noncompliance in the FY 2010 ACD, it identified several factors "which, together, constituted circumstances that triggered section 101(d)'s failsafe protections." Order No. 1427, p. 9. The Commission gave itself maximum wiggle room, explaining that the exact set of factors is not necessary for a finding of noncompliance: "variants of those factors could also trigger the protections of section 101(d). Moreover, other factors not present in the FY 2010 ACR, could emerge to support a conclusion that an extreme case requiring action under section 101(d) existed." *Id.* The Commission concluded that "while circumstances justifying invocation of section 101(d) may vary, in making any such determination, the Commission considers the totality of the circumstances presented.… The[] identification [of the relevant factors in FY 2010 ACD] does not, however, precluding the conclusion that other combinations of those, or other, relevant factors may authorize action under section 101(d)." *Id.*, p. 10.

costs of postal operations to all Standard Mail users." FY 2010 ACD, p. 106. Yet, the Postal Service remains in noncompliance. Title 39 does not permit such a result. According to 39 U.S.C. § 3653(c), once the Commission makes such a finding, it "**shall take appropriate action** in accordance with [39 U.S.C. § 3662(c)]...." (Emphasis added.) Thus, section 3662(c) requires the Commission to "order the Postal Service [to] take such action as the Commissions considers appropriate in order [**both**] (i) to achieve compliance with the applicable requirements **and** (ii) to remedy the effects of any noncompliance.

Here, once the Commission has properly found Standard Flats pricing violated PAEA it became "**obligated**" by section 3662(c) to provide what the U.S. Court of Appeals describes as an "adequate remedy," one that redresses the wrong both by bringing the Postal Service into compliance with the law and by remedying any effects of prior noncompliance. *See* Gamefly, Inc. v. Postal Regulatory Commission, 704 F.3d 145, 149 (D.C. Cir. 2013) (emphasis added). In Gamefly, the Commission "issued an order finding that the Postal Service was indeed discriminating against Gamefly," in violation of 39 U.S.C. § 403(c), which, in pertinent part, requires the Postal Service to "provid[e] services and ... establish classifications, rates and fees" that do not "make any undue or unreasonable discrimination among users of the mails." *Id.* at 146. But the Court of Appeals ruled that **the Commission's "remedy left much of the discrimination in place**." *Id.* (emphasis added). Indeed, the remedial order issued by the Commission in the Gamefly complaint docket, Docket No. C2009-1, was inadequate as it "could still require GameFly to 'continue to to generate more than double, the contribution per piece than Netflix mail.'" *Id.* at 149. The court of appeals ruled that the Commission's order was "arbitrary and capricious because it **left discrimination in place** without reasonable explanation." *Id.* (emphasis added). Vacating the Commission's order, the court remanded the case "for an adequate remedy," instructing the Commission that is "**must** either remedy all discrimination or explain why any residual discrimination is due or reasonable under §403." *Id.* at 149 (emphasis added).

As in Gamefly, the current directive to the Postal Service relating to Standard Flats has proven inadequate to resolve the Standard Flats problem. The violation of Title 39 continues, and Standard Mail prices failed "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 Commission's remedy has failed to resolve the unfairness and inequity of requiring other mailers to cross-subsidize Standard Flats for years on end, and into the foreseeable future. This unfairness and inequity will continue with no end in sight, as the Postal Service admits. *See* Postal Service response to ChIR No. 2, Question 1.c.

Section 3662(c) requires the Commission to "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**...." The court's decision in Gamefly made it clear that an adequate remedy cannot just tend in the direction of an improvement of noncompliance, but (i) must remedy it fully, and beyond that, (ii) undo the damage of prior losses. Unless and until the Commission orders that prices for Standard Mail Flats be increased to cover costs and make a contribution to institutional costs and repair the damage the product has done to the Postal Service since FY 2010, that remedy, according to the standard established by the U.S. Court of Appeals, will be inadequate and arbitrary and capricious.

V. The Commission Can No Longer Base Decisions on the Unsupported Hope that the Costs of Flats Will Be Reduced Significantly in the Coming Years.

The handling of most flats has always been inherently more costly than letters, despite years of work on the problem.[38] The Postal Service has repeatedly promised that the cost of handling flats will drop significantly, but it is now clear that this neither has happened, nor will be happening in the foreseeable future. The Postal Service has offered false promises about declining flats costs for many years, which the Commission has accepted, but it would be irresponsible if one were to repeat that mistake again. Since Standard Flats costs cannot be cut, the remedy must be by price increases.

A. Coverage by Flats Products.

Table V-1 shows coverage of five selected products used exclusively (or primarily) by flat-shaped mail for the period 2008 to 2013. Three of those products have exhibited sustained profitability. The other two products, Standard Flats and Outside County Periodicals (shaded in the chart), however, have been deeply **unprofitable for every one of these six years**. The reason that these two products have been underwater is that flats handling costs have been disregarded, in the hope of a better tomorrow, so that prices would be arbitrarily held down by the Postal Service. To avoid price increases, the Postal Service claims it will achieve cost

[38] Saturation flats, which require no sorting by the Postal Service, have a low unit cost and are not included in this discussion. (In County Periodicals, which have comparatively small volume, also are not included in this analysis.)

savings and those promises have been deferred to by this Commission under a serious misapplication of the statutory doctrine of "pricing flexibility."[39]

Table V-1
Cost Coverage of Selected Flats Products
FY 2008 – 2013

Fiscal Year	First-Class Flats	Carrier-Route	Standard Flats	Outside County Periodicals	BPM Flats
2008	157.77%	150.54%	94.16%	82.94%	166.26%
2009	164.07%	143.96%	82.15%	75.03%	173.72%
2010	145.15%	142.51%	81.59%	74.99%	147.20%
2011	144.58%	134.84%	79.26%	74.99%	162.80%
2012	148.99%	130.44%	80.73%	71.84%	134.34%
2013	149.48%	133.39%	84.88%	75.82%	141.67%

Source: CRA.

B. Unit Cost of Flats in FY 2013 Compared to Prior Years.

Despite aggressive Postal Service efforts to cut flats handling costs, the unit cost of each of the five flats products in Table V-2 increased between FY 2008 and FY 2013. *See* Table V-2. Postal Service handling of flats is expensive, and mailer presorting reduces the Postal Service's costs substantially. Therefore, not surprisingly, the two products that are the

[39] In the case of Standard Flats, Valpak has persistently urged the Postal Service to use its pricing flexibility so as to materially increase coverage. The Postal Service, however, has adamantly refused to do so and the Commission has found noncompliance, but allowed its remedial order to be largely disregarded, resulting in a continuing problem. In the case of Periodicals, the Postal Service has articulated a somewhat different assortment of excuses to avoid any finding of non-compliance. *See*, *e.g.*, Order No. 1926, p. 138.

least presorted, First-Class Flats and Standard Flats, had the largest increase in unit cost — $0.127 and $0.063, respectively.

Table V-2
Unit Costs of Selected Flats Products
FY 2008 – 2013

Fiscal Year	First-Class Flats	Carrier-Route	Standard Flats	Outside County Periodicals	BPM Flats
2008	0.761	0.150	0.389	0.339	0.544
2009	0.753	0.160	0.448	0.363	0.498
2010	0.865	0.165	0.448	0.364	0.563
2011	0.872	0.177	0.463	0.365	0.498
2012	0.874	0.189	0.465	0.377	0.600
2013	0.888	0.187	0.452	0.363	0.568

Source: CRA.

During this last year (from FY 2012 to FY 2013), for the various flat-shaped products in Table V-2, unit cost changed little, although the unit cost of the two flat-shaped products in Standard Mail, Carrier Route and Flats, finally declined slightly by 1.0 and 2.8 percent, respectively. (The costs of High-Density/Saturation Letters and Flats declined even further.) However, it is by no means clear that this small decline in unit cost reflects increased productivity. The Postal Service offers no insight:

> No analysis has been performed to isolate the cost savings resulting from these [indicated] initiatives, assuming that such analyses are even possible with available data. [Postal Service Response to ChIR No. 2, Question 1.]

Nevertheless, some observations about these costs are possible. Some, perhaps all, of the decline in unit cost doubtless reflected lower compensation cost, as explained in the 2013 Report on Form 10-K:

> The decrease in compensation expense is also driven by our staffing composition between career and non-career employees in the workforce. In 2013, the rapid rise in the use of non-career labor allowed us to replace more expensive career workhours with less expensive non-career workhours. The rate paid to non-career postal workers is less than the rate paid for career employees.… The number of non-career employees increased by approximately 26,000 in 2013 to 127,000 employees as a result of the increased workforce flexibility available under the new collective bargaining agreements. This increased flexibility allowed us to more efficiently manage the workforce and reduce the average cost per work hour in 2013 below the 2012 level.… **The net result** of these changes in work hour mix **was a 1.0% decrease in the average hourly compensation and benefit wage rate.** [2013 Report on Form 10-K, p. 29 (emphasis added).][40]

Year after year, the Postal Service has speculated, and the Commission has deferred, that substantial declines in the unit costs of underwater flat products not only were achievable, but with a little patience also would materialize.[41] No good reasons were ever asserted as to why costs would decrease, but such statements appear in each ACR. *See*, *e.g.*, FY 2012 ACD, at 116. In retrospect, it must be seen that those speculations were erroneous.

---

[40] The response to ChIR No. 2, Question 1 provides additional detail on the percentage change in productive hourly rates, but the extent to which these reductions were responsible for the observed reductions in unit cost is not indicated.

[41] In a moment of transparency, the Postal Service expressed reservations concerning its ability to materially reduce the cost of flats in the Joint Periodicals Study (September 2011).

In the era of PAEA, the Postal Service does not submit sworn testimony to support its Annual Compliance Report. It simply makes institutional representations for which no individual is ever held responsible or accountable. However, sworn testimony is still required in exigent pricing dockets. It is instructive to look back at the last such docket, the most recent exigent rate case, to see what statements were made by Postal Service witnesses under oath that the Commission adopted. In Docket No. R2013-11, Postal Service witness Taufique was the pricing witness on whom the Commission relied:

> Taufique asserts that the Postal Service "cannot afford to adopt a short-term perspective and take actions that will 'fix' a coverage problem by permanently driving mail—mail that [the Postal Service] **believe[s] will become profitable** as the Postal Service and the mailing community adjust to operational and marketplace realities—or mail that is valued[42] in the mailbox—out of the system." [Docket No. R2013-11, Order No. 1926, p. 161 (emphasis added).]

Witness Taufique's "belief" concerning future profitability was based on nothing. It was only thin cover for the Postal Service's misguided pricing strategy. Such Postal Service "beliefs" are presented to furnish the Commission using language resembling a fact and have been quoted in its Determination to justify deference to the regulated entity and inaction by the regulator. If the Postal Service had some "magic bullet" to reduce flats costs, it surely would have used it by now. The unavoidable conclusion, therefore, is that even though he does not

---

[42] By way of further justification for underwater pricing, witness Taufique asserts that catalogs are "valued in the mailbox." Does he imply that all the Standard Mail advertising products that (i) are profitable to the Postal Service and (ii) underwrite the subsidy to Standard Flats have relatively less value in the mailbox? Since he cites no evidence or authority for such a view, it presumably reflects his own personal opinion (and perhaps that of others with whom he works). This view could scarcely be more subjective and arbitrary, which seems to be consistent with how the Postal Service sets prices.

expressly mention costs, since prices scarcely changed, witness Taufique's speculation of future profitability is based on some future significant reduction in the cost of Standard Flats in the next year or two. Statements by Postal Service witnesses are made under oath and it is time the Commission carefully examine these representations, rather than accept them at face value.

Just to break even (*i.e.*, coverage equal to 100 percent) would require that Standard Flats unit cost remain static for well over one, perhaps two decades; *see* Table II-2, *supra*. How a significant cost reduction is supposed to be achieved, of course, is neither explained by witness Taufique (but he would demur to such a question, as he is just a pricing witness), nor does he point to any record evidence, either in this docket or any other docket, to support his "belief."

C. Outlook for Unit Cost of Flats.

The Postal Service recently published a draft version of A Strategic End-to-End Guide for Flats Planning (October 2013) ("The Guide").[43] That document discusses what the Postal Service has done, is doing, and plans to do with respect to flats processing. Most of the report could be reduced to one sentence: The Postal Service hopes to reduce the end-to-end cost of handling flats by having a higher percentage DPS'd on FSS machines.

---

[43] https://ribbs.usps.gov/industryoutreach/documents/tech_guides/FlatsStrategyDRAFT.pdf (since removed by the Postal Service after the Commission issued a ChIR referencing it, but a cached version was retained by Google at http://webcache.googleusercontent.com/search?q=cache:fd1DCDv6i3EJ:https://ribbs.usps.gov/industryoutreach/documents/tech_guides/FlatsStrategyDRAFT.pdf).

The desirability of and need for reducing the unit cost of flats is clear. However, for reasons discussed below, the Postal Service has no reason whatsoever to believe a near-term major cost reduction that would result in Standard Flats profitability (*i.e.*, coverage in excess of 100 percent) will occur.[44] The Guide demonstrates that only some small, marginal reductions in the average unit cost of all flats may be achievable.

According to The Guide (p. 12), flats were distributed in FY 2012 by means of the following methods:

- AFSM 71.4%
- FSS 17.9%
- Manual 8.5%
- UFSM 2.2%

We examine what the Postal Service says about each type of processing in a quest to identify what the Postal Service could possibly believe to be future sources of cost savings.

1. The AFSM 100.

The AFSM 100 has been in service many years, and has been a workhorse for the Postal Service. "As of 2013, 534 Automated Flats Sorting Machines (AFSM) 100 continue to be in operation." The Guide, p. 13. This entire fleet of AFSM 100s previously has been upgraded with barcode readers ("BCRs") and optical character readers ("OCRs"). The AFSM 100 thus represents a mature technology. No productivity improvements on the AFSM 100s

---

[44] For years, the Commission elected to postpone action that would have improved coverage and instead wait on the "forthcoming" Periodicals Mail Study, Joint Report of the USPS and PRC (September 2011) to point the way to meaningful cost reductions for both Flats and Periodicals, reductions that have yet to materialize. http://about.usps.com/postal-act-2006/periodicals-mail-study.pdf.

are either discussed or anticipated in The Guide.[45] Consequently, the average unit cost of flats processed on AFSM 100s seems likely to remain unchanged into the future, except perhaps for changes in labor costs.

2. The FSS Machine.

In May 2008, the Postal Service purchased a fleet of 100 FSS machines. As the last FSS was deployed in August 2011 (*id.*, p. 22), all 100 machines were in operation during FY 2012 and FY 2013.

> The Postal Service now has the ability to sort flat mail in Delivery Point Sequence (DPS) for approximately 21% of delivery routes. In FY 2012 4.5 billion (18.0%) flats were sorted on the FSS. The FSS **enabled the Postal Service,** for the first time in our history, **to reduce labor-intensive manual casing of flats by carriers.** [*Id.*, p. 22 (emphasis added).]

FSS machines are both expensive and large. They are housed in facilities separate from SCF plants. Some FSS facilities are co-located with SCF facilities, whereas others are not. The 100 FSS machines are apparently installed in 46 locations throughout the country. The Guide, p. 23. Despite whatever promise FSS machines might have for reducing the unit cost of flats, any further expansion of the fleet of 100 FSS machines in the near term appears unlikely. Without mentioning litigation between the Postal Service and the manufacturer of the FSS, The Guide explains:

> The Postal Service evaluated a follow-on contract to purchase additional FSS machines from the existing manufacturer. The initiative **was not pursued** due to flat mail volume decline and significant investment required. [*Id.*, p. 27 (emphasis added).]

---

[45] The Guide states only "the Postal Service continues modifying the AFSM 100 machines to increase operational efficiency and reduce maintenance downtime." *Id.,* p. 30.

Even if the Postal Service should decide to purchase additional FSS machines (or any other follow-on machines), a substantial lapse of three or more years can be anticipated between purchase date and subsequent full deployment. The Postal Service thus seems years away from any major expansion of its ability to DPS flats. At best, therefore, only relatively small productivity improvements can be anticipated in processing the 25 to 30 percent of flats that are within the capacity of the existing 100 FSS machines.

3. Manual Processing.

Such manual processing as continued to occur in FY 2013 was said to be associated chiefly with bundle breakage or machine rejects. *See* Postal Service Response to ChIR No. 2, Question 1. However, the Postal Service still has some "postal facilities with only manual flats processing." *Id.* The Postal Service is endeavoring to reduce each of these two sources of manual processing. It would appear that assigning flats directly to manual processing (*e.g.*, to meet critical dispatch deadlines for Periodicals, or to keep excess workers busy — contentions which have been hotly disputed in prior years) appears to be a thing of the past. Since manual processing is relatively expensive, reductions in the volume processed manually could help moderate increases in unit cost.

The level of manual processing in FY 2013 is a more recent benchmark:

> While the percentage of manually processed flats increased from 8.5% to 9.4% in FY 2013, the Postal Service attributes this increase to initial plant consolidation activities, most of which occurred during the fourth quarter of FY 2013. We expect to see the percentage of manually processed flats decline as we realize the benefit of these consolidations in FY 2014. [Postal Service Response to ChIR No. 2, Question 1]

Accordingly, the elevated level of manual processing in FY 2013 leaves some hope for a small decline in unit cost associated with manual processing in FY 2014.

4. The UFSM.

According to The Guide, all remaining UFSMs are being removed from service. However, complete removal of all UFSMs (if that has not already occurred) can be expected to have minor, almost negligible impact on the future unit cost of all flats because only 2.2 percent of all flats were distributed on the UFSMs in FY 2012. It is conceivable that flats previously sorted on UFSMs will be processed at lower cost on AFSM 100s or FSS machines, but the volume shifted after FY 2013 obviously will be but a small percentage of all flats. Consequently, any possible reduction in the average unit cost of all flats on this account necessarily will be very small.

5. Summary: Achieving Significant Cost Reduction Is Highly Doubtful.

Approximately 70 percent of all flat-shaped mail will continue to be distributed on AFSM 100s and then cased manually by carriers. Thus there is little reason to anticipate any reduction in the unit cost of processing of 70 percent of all flats.

After the UFSMs are fully retired, the amount of manual processing is reduced, and various marginal improvements made to increase utilization of the existing FSS fleet, and assuming no further expansion of the FSS fleet, the profile of mail distribution seems likely to settle at approximately these levels:

- AFSM 70% (down from 71.4%)
- FSS 25% to 28% (up from 17.9%)
- Manual 2% to 5% (down from 8.5%)

This distribution represents some small improvement over the FY 2012 distribution shown previously, but is not indicative of any major cost reduction breakthrough beyond that achieved in FY 2013. Any improvement in coverage on account of reduction in average unit cost seems likely to be small at best. COLA clauses in labor contracts will challenge the Postal Service just to keep unit cost at the slightly reduced levels attained in FY 2013.

Although the Postal Service likes to make much about the fact that it can DPS flats on the FSS machine, to date that has been less than an unmitigated success. FSS has presented the Postal Service and flats mailers with a number of problems, such as:

- Damage to mailpieces,
- Earlier processing and cutoff times,
- Separate location of some FSS and SCF facilities,
- The need for separate presort schemes for FSS and non-FSS zones, and
- Different optimum preparation requirements for FSS and non-FSS zones. [The Guide, pp. 16-17.]

According to The Guide, the Postal Service is endeavoring to address these issues and reduce the cost of peripheral activities associated with the FSS, such as bundle sorting, bundle opening, loading of containers that feed the FSS, etc. The Postal Service does not publish separate cost records for: (i) flats that are AFSM-processed and then manually sorted by carriers; and (ii) flats that are DPS'd on FSS. Thus, it is possible that, to date, the FSS deployment has had no effect on the end-to-end unit cost of flats, and it may even have caused a slight increase.

Given time, the Postal Service hopefully may achieve some small success with regard to improvements in FSS utilization and reductions in the end-to-end cost of flats DPS'd on the existing fleet of FSS machines. The Postal Service Response to ChIR No. 2, Question 1, indicates small marginal improvements may be achieved in: (i) throughput per hour; (ii) percent DPS'd; and (iii) bundle sorting on APPS and APBS. The effect of these improvements on unit cost is not identified, but likely is rather small.

Since major cost saving from processing flat products appears unattainable anytime in the next few years, the principal hope for improving Postal Service liquidity by decreasing what has come to be the perennial deficit associated with Standard Flats would seem to lie in further reductions in volume. The fact that reducing the volume of underwater products improves the Postal Service's net contribution was illustrated by comments of MPA, *et. al.* in the recent exigent rate case, Docket No. R2013-11. Even the Commission took note.

> If anything, the only effect of the Great Recession would have been **a lessening of Postal Service's losses by the recession-induced reduction in the volume of these products** [Standard Flats and Periodicals]. [*Id.* at 4 (citing MPA, *et al.*); Order No. 1926, p. 164 (emphasis added).]

So long as Standard Flats are deeply underwater, the Postal Service has benefitted financially from reductions on the volume of that product. Indeed, without Standard Flats volume losses, the Postal Service would be in much worse financial shape than it is today.

VI. The Postal Service Has Refused to Pursue Necessary Cost-Cutting Steps, Particularly in the Delivery Network, in Violation of the Title 39 Mandates of Costing, Efficiency, and Rate Predictability.

The Postal Service FY 2013 ACR seeks to "demonstrate that all products during such year complied with all applicable requirements of [title 39]." Yet scant attention is given to the mandates of Title 39 relating to cost cutting and efficiency, topics that repeatedly appear in the law. USPS FY 2013 ACR, p. 1.

- 39 U.S.C. § 101(a) requires the Postal Service to provide "efficient" services.
- 39 U.S.C. § 403(b)(1) requires the Postal Service "to maintain an **efficient** system of collection, sorting, and delivery of the mail nationwide." (emphasis added).
- 39 U.S.C. § 404(b) requires the Governors to establish rates and fees "to enable the Postal Service, under best practices of honest, **efficient**, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States." (emphasis added).
- The first two "Objectives" set out in 39 U.S.C. § 3622(b) require rates that "maximize incentives to reduce costs and increase **efficiency** [and] to create predictability and stability in rates." 39 U.S.C. § 3622(b)(1) and (2) (emphasis added).
- One of the "Factors" specifies that the reason a measure of pricing flexibility is given to the Postal Service is "to encourage … operational **efficiency**…." 39 U.S.C. § 3622(c)(7) (emphasis added).
- Another of the "Factors" establishes "the need for the Postal Service to increase its **efficiency** and **reduce its costs**, including infrastructure costs, to help maintain high qualify, **affordable** postal services…." 39 U.S.C. § 3622(c)(12) (emphasis added).

Disregarding these several statutory mandates, the Postal Service does not appear to believe that it is required to demonstrate in its ACR that it has taken all steps to reduce costs and increase efficiency so that rates would be predictable and stable. Certainly this issue is not addressed in the 56-page ACR itself or its attachments. The Postal Service's 2013 Annual Report to Congress provides in a portion of one paragraph summary information on cost cutting. 2013 Annual Report, p. 3. The FY 2013 Performance Report and FY 2014 Performance Plan provides one similar summary paragraph (pp. 40, 42), and additional information on changes in the workforce (p. 64). While costs are discussed in the Postal Service's FY 2013 Form 10-K, cost-cutting discussion is primarily limited to the bottom half of p. 49 of that document — "Postal Actions to Improve Liquidity."

Postal Service costs are not being cut aggressively. Even some cost savings measures are being reversed. The Postal Service was reported to have approved a 1-percent wage increase for all non-contract employees effective January 25, 2014. Also, the Postal Service suspended its Network Rationalization plans.[46]

Nowhere in this docket does the Postal Service discuss even the possibility of saving billions of dollars annually by converting expensive door delivery to much less expensive curbside delivery — an area considered highly significant by the Postal Service's Office of the

---

[46] *See* K. Howell, "Postal Service Slow to Cut Costs, Quick to Raise Price," *The Washington Times* (Jan. 29, 2014), http://www.washingtontimes.com/news/2014/jan/29/postal-service-opts-for-stamp-hike-over-deeper-spe/.

Inspector General ("OIG"), and one where cuts soon may be forced on the Postal Service by the House of Representatives.[47]

These issues were raised by Valpak in Docket No. R2013-11, to demonstrate that the Postal Service had neither been aggressive in cost cutting, nor followed best practices, and therefore was not entitled to an exigent price increase. *See* Valpak Initial Comments (Nov. 26, 2013), pp. 95-99. The Commission's response was to state that in an exigent case its "analysis of best practices is primarily **forward-looking**" and the "arguments made by the commenters are not sufficient to persuade the Commission that the Postal Service's management practices have rendered an exigent rate increase unnecessary or less necessary to enable the Postal Service to maintain and continue the development of needed postal services. Even if the Commission found ... that the Postal Service did not take every available step to cut costs before filing its Request, that fact alone would not be a sufficient basis to deny the Request." Order No. 1926, pp. 128, 131 (emphasis added).

In this Annual Compliance Review docket, however, the Commission's view is **backward looking** to FY 2013. If the Postal Service did not undertake a substantial cost-cutting opportunity that was fully legal and available to it to undertake which results in the Postal Service not fulfilling the efficiency and cost cutting mandates of Title 39, the issue should be considered by the Commission afresh in this docket. Therefore, Valpak offers again

---

[47] G. Strauss, "Could door-to-door Postal Service delivery end soon?" *USA Today* (July 24, 2013) http://www.usatoday.com/story/news/2013/07/23/postal-service-mail-delivery-to-your-door-could-soon-end/2580645/.

many of the comments that it filed in Docket No. R2013-11 for the Commission's re-consideration in this different context.

The OIG published an extensive report **over two years ago** on this cost-cutting proposal entitled "Modes of Delivery."[48] The OIG determined that by converting existing delivery from door to curbside, the Postal Service could save an astounding **$4.5 billion annually.** Once realized, savings from converting door to curbside delivery:

- would be ongoing,
- would greatly exceed the $1.78 billion in additional revenues being sought through an exigent rate increase, and
- would not be limited to a one-time recovery for prior losses, as revenues from a lawful exigent rate increase should be.

Highlights from that OIG report include the following:

- "[T]he Postal Service should develop a comprehensive strategic plan to aggressively move from existing door-to-door delivery to curbside delivery, which **could save more than $4.5 billion a year.**" [*Id.* at 2 (emphasis added).]
- This strategic plan would significantly reduce delivery costs and **could be implemented internally** through policy changes. It **would not require congressional approval,** unlike other significant cost-savings initiatives, such as moving from 6- to 5-day delivery. At the same time, these changes would increase fairness and consistency of service to customers, as curbside delivery would be the primary delivery mode. [*Id.* (emphasis added).]
- **The delivery operation is** the Postal Service's **largest cost center** with mail delivery occurring 6 days a week. **Door-to-door delivery is the most expensive mode** of delivery, costing the Postal Service as much as $353 per delivery point, **totaling $12 billion annually.** Curbside delivery is more cost effective, because it allows the carrier to remain in the vehicle and deliver mail from the street to a mailbox or grouping of mailboxes. [*Id.* (emphasis added).]

---

48 OIG, Modes of Delivery, DAR-AR-11-006 (July 7, 2011). http://www.uspsoig.gov/sites/default/files/document-library-files/2013/DR-AR-11-006.pdf

- [While] it could be difficult to make these changes, … some deliveries may never be candidates for conversion. On the other hand, **the Postal Service must take every opportunity to cut these significant delivery costs.** [*Id.* at 3 (emphasis added).]
- As of December 31, 2010, more than 35 million door-to-door delivery points exist nationwide, **costing the Postal Service billions in excess costs.** [*Id.* at 4 (emphasis added).]

According to the OIG report, some 51.1 million residences received curbside delivery in 2011 (and another 35.8 million residences received centralized delivery that year). Most of the savings from converting door-to-curb delivery likely would constitute a reduction in fixed costs[49] — not necessarily increasing contribution, but most definitely increasing liquidity.

The Postal Service generally regards both mailers and recipients of mail to be "customers." The Postal Service should note, though, that those who originate mail are **paying** customers, whereas those who receive mail (recipients or addressees) are **non-paying** customers.[50] Why the Postal Service avoids reducing the premium level of service given free to some **non-paying** customers is unclear. If the Postal Service truly were in a financial "crisis," and needed to reduce cash outlays and improve liquidity, it would seem more reasonable for the Postal Service to be concerned about preferences of its **paying** customers, who prefer to keep rates within the CPI cap and who might take their much-needed cash and go elsewhere if prices escalate above CPI.

---

[49] Curbside delivery would replace foot delivery, hence much of the savings would be a reduction in route time, which is a fixed cost.

[50] Postal Service management opposes the OIG suggestion, and has a ready list of reasons as to why it cannot be done. *See* OIG Report, Appendix E. The House of Representatives Committee on Oversight and Government Reform appears not to be impressed.

The plan to curtail door delivery is not beyond the pale. Canada Post has announced that it will phase out all residential door delivery over the next five years.[51] The Postal Service simply cannot afford to continue to offer door delivery, especially with a declining number of pieces per delivery point. While some major cost-savings initiatives are contingent upon Congressional action, that is certainly not true with respect to conversion of door delivery to curbside delivery. The Postal Service likes to blame Congress for dragging its heels on the Postal Service's cost reduction proposals, but the feeling well could be mutual — *i.e.*, Congress may feel the Postal Service has the flexibility, but not the wherewithal, to achieve major cost reductions. No doubt many in Congress would like to see the Postal Service get really serious about complying with Title 39 by running an efficient, lean organization, rather than relying on exigent rate increases in lieu of further cost reductions. This could help explain why Congress seemingly perceives little urgency to move pending postal reform legislation.[52]

Truly, the issue of converting delivery from door to curbside presents the Postal Service with an opportunity for enormous savings, but the Postal Service chooses not to pursue it. It declines even to consider the issue and report to the Commission about the issue in this

---

[51] *See* Canada Post's Five-Point Action Plan, http://www.canadapost.ca/cpo/mc/aboutus/corporate/ap.jsf. ("The one third of Canadian households that still receive their mail at their door will be converted to community mailbox delivery over the next five years.")

[52] In Docket No. R2013-11, witness Nickerson mistakenly tried to put most or all of the blame for the Postal Service's deteriorating finances on Congress when he noted that: "timely passage of comprehensive postal reform legislation that adequately addresses the shortcomings in our business model has not occurred in the past three years, nor can it be assured to occur at any time in the future...." Nickerson Statement, p. 14, ll. 7-10.

docket. It seems strange that Congress may need to impose those savings on the Postal Service, over management's objections. And, in time, as both the volume and value of mail per mail stop decline, while the cost per stop for door delivery continues to creep upward, the economics of converting from door to curbside delivery inevitably will become overwhelming. By refusing to pursue these cost savings, which dwarf the revenue the Postal Service expects to obtain from price increases imposed on **paying** customers, the Postal Service obviously considers it easier, in some sense, to demand an exigent price increase than to face some irritated, **non-paying** customers.

If the Postal Service truly believes that door delivery is necessary in order to provide "postal services of the kind and quality adapted to the needs of the United States," then it needs to explain why more than 52 million residences that currently receive only curb delivery do not need higher-quality door delivery, and why the Postal Service is not making an effort to convert all residences now receiving curb (and cluster-box) delivery to door delivery. Alternatively, it needs to explain why a minority of residences (28 percent) require very expensive, high-quality door delivery while the much larger majority is consigned to a mode of delivery that is considerably less expensive and undeniably of lower quality.

Now that the Commission has approved the exigent rate increase in substantial part, the extra funds generated from those higher rates will be used to pay for expensive door delivery for persons living in older suburban homes. The Postal Service does not believe that circumstances are sufficiently dire that these costs should be cut at this time. It should be the role of the Commission to require the Postal Service to cut costs and achieve efficiency and to obey the law — if necessary by forcing it to confront decisions that it would rather avoid.

Requiring the Postal Service to curtail very expensive door delivery for a privileged few would be the right place for the Commission to start in its enhanced focus on Postal Service costs.

The question which Valpak urges the Commission to address clearly and directly and to rule upon is that the Postal Service's failure to even begin to curtail door delivery where it currently exists consistent with cost cutting and efficiency required by many provisions of Title 39 as set out *supra*. If so, the Commission should require the Postal Service report on how cost-cutting plans such as that recommended by the Inspector General and contained in the House version of the Postal Reform Act, H.R. 2748 could be implemented, and if not, why not.

To sum up, such cost-cutting as the Postal Service has done is inevitably described as "aggressive." Not described, however, is the complacency toward major cost reduction initiatives **not** taken.

CONCLUSION

The Commission should exercise its clear statutory responsibility, make findings of noncompliance as discussed herein, and order prompt and comprehensive remedial actions by the Postal Service.

Respectfully submitted,

/s/

William J. Olson
Jeremiah L. Morgan
John S. Miles
WILLIAM J. OLSON, P.C.
370 Maple Avenue West, Suite 4
Vienna, Virginia 22180-5615
(703) 356-5070

Counsel for:
Valpak Direct Marketing Systems, Inc. and
Valpak Dealers' Association, Inc.