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Before the
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2013 | Docket No. ACR2013

PUBLIC REPRESENTATIVE REPLY COMMENTS

(February 14, 2014)

Respectfully submitted,

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TABLE OF CONTENTS

Page

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In accordance with the Commission's Notice in this proceeding,[1] these Public Representative Reply Comments respond to Comments on the Postal Service's Annual Compliance Report (ACR2013) prescribed by 39 U.S.C. 3652.[2] Six initial comments were filed by participants in this proceeding.[3]

The Postal Service's ACR is "to demonstrate that all products during the year complied with all applicable requirements of [title 39]." 39 U.S.C. 3652(a)(1). These Reply Comments address matters raised by other participants in their Comments concerning:

(1) continuing negative contribution and cross-subsidy of Standard Mail Flats (Valpak and ACMA);

(2) cross subsidy of certain other products and improper cost avoidance methodology (Pitney Bowes);

(3) recent decline in the proportion of costs attributable to competitive products and outdated sharing requirement (UPS); and

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[1] Notice of Postal Service's Filing of Annual Compliance Report and Request for Public Comments, December 30, 2013. Reply Comments are due on or before February 14, 2013. .

[2] United States Postal Service FY 2013 Annual Compliance Report (ACR2013), December 27, 2013.

[3] In addition to Comments of the Public Representative, initial comments were filed on January 31, 2014, by (in alphabetical order) American Catalog Mailers Association (ACMA), Greeting Card Association (GCA), Pitney Bowes Inc. (Pitney Bowes), United Parcel Service (UPS) and Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (Valpak).

(4) Postal Service revisions of work papers that moved Parcel Select cost coverage to above 100 percent (Postal Service 2013 ACR Errata).

I. STANDARD MAIL FLATS' CONTINUING NEGATIVE CONTRIBUTION

The weight of the Comments focused on the continuing failure of Standard Mail Flats to reach 100 percent cost contribution. Valpak argues for accelerated rate increases while ACMA contends the rates are sufficient.

A. Valpak''s Multi-period Costing Model Is Useful But Does Not Dictate Further Remedial Action At This Time

In its Initial Comments, Valpak states that Standard Mail pricing, being "inequitable and unlawful," has become even worse in FY 2013.[4] Valpak characterizes Standard Flats as a "deeply underwater" product. *Id.* at 23. While recognizing that Standard Flats' cost coverage has increased, Valpak does not find the increase of 4 percentage points sufficient. *Id.* at 5. Valpak repeats the concerns, previously addressed in Docket No. R2013-11,[5] that the Postal Service does not cut costs aggressively. Valpak Initial Comments at 76-77. In discussing costs for Standard Mail Flats, Valpak concludes that since their "costs cannot be cut, the remedy must be by price increases." *Id.* at 63. In the current docket, Valpak provides a multi-period pricing model[6] which, as it hopes, would allow "the user to identify those prices which increase the contribution obtainable under a price cap up to the maximum available, if desired." *Id.* at 23

[4] 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 (Valpak Initial Comments) at 5.

[5] Docket No. R2013-11, Initial Comments of Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc., November 26, 2013 at 95-99.

[6] This is a modified version of the model previously submitted in Dockets Nos. ACR2012 and R2013-11. The most recent model submitted in the current docket is called Standard Mail contribution maximization model "2014 version". Valpak Initials Comments at 20.

The Public Representative supported Valpak's pricing model in the review of the FY 2012 ACR, and still believes that the model might provide a helpful tool for establishing prices. However, the suggested multi-period pricing model is an alternative method, which, as noted by Valpak, "is only designed to help the Postal Service set pricing priorities" and "gives no assurance that the Postal Service will be profitable". Valpak Initial Comments, Appendix at 32. The Public Representative acknowledges the recent improvement of the model that enables it to cover prices for more than one year. However, the model still has certain simplifications that might decrease its effectiveness, especially if used in the long run.

First, the model relies heavily on elasticities estimated by the Postal Service, and applies the most recent elasticities filed with the Commission on January 22, 2014, and assumes that "elasticities remain the same in each successive period." *Id.* at 4. However, in spite of Commission recommendations, elasticity for Standard Mail is still not available by product, and, as the Public Representative noted in the initial comments in these proceedings,[7] the majority of Standard Mail products become more elastic over time. Public Representative Initial Comments at 29-30.

Second, the model might need to account for changes in volumes due to the classification change and transfer of the Standard Mail products to the competitive product list. These changes have been recently initiated by the Postal Service, and might continue in the future. The results of the model after accounting for changes in volumes would likely be very different.

Valpak acknowledges the above concerns about its model. It states that "in each successive year actual volumes and unit costs, as well as estimated elasticities, may change in ways not assumed by the model." Valpak Initial Comments at 28. Under current circumstances, as the Public Representatives stated in the initial comments in this proceeding, the continued improvement in cost coverage for Standard Flats proves

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[7] Public Representative Comments, January 31, 2014 (Public Representative Initial Comments).

the effectiveness of the current method that includes above CPI price increases for Standard Mail Flats. Public Representative Initial Comments at 29.

B. Valpak Has Not Demonstrated the 2010 ACD Remedial Order Is Being Ignored

Valpak refers to the Commission's remedial order in the FY 2010 ACD and states that the Postal Service was directed to implement "both cost cutting and price increases as part of the remedy." Valpak Initial Comments at 6. Valpak concludes that this order "has been disregarded and frustrated by the Postal Service." *Id.* However, as the Commission stated in the ACD 2012, "under current circumstances, the Postal Service is making reasonable progress toward addressing the issues raised in the 2010 ACD, [and] that ***no changes in the 2010 ACD directive are necessary….*** " (Emphasis supplied.) ACD 2012 at 22.

1. Commission directives in ACD 2010 and ACD 2012

In the ACD 2010, [p]ursuant to the authority of 39 U.S. C. 3653(c), the Commission directed "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." ACD 2010 at 106. The Commission also provided a more detailed guideline that the Postal Service should follow in subsequent years until the Standard Flats product reaches more than 100 percent cost coverage. *Id*. at 107. These guidelines include (1) a schedule of future above-CPI price increases for Standard Mail Flats to be developed by the Postal Service and updated consistently with Market Dominant Price Adjustment(s) and ACRs; and (2) information on the steps the Postal Service is taking to eliminate the intra-class cross subsidy with respect to Standard Mail Flats. *Id.*

In its FY 2012 ACR, the Postal Service presented a three-year schedule of above CPI price increases for Standard Mail Flats. ACD 2012 at 110. The planned price increase for Standard Mail Flats is 5 percent above CPI, and it was not modified in the FY 2013 ACR. ACR 2013 at 20.

In FY 2012, Standard Flats cost coverage increased by 1.6 percent (from 79.3 percent to 80.9 percent), and in FY 2013 cost coverage increased by 4 percent, and reached 84.9 percent. ACD 2012 at 108 and ACR 2013 at 17. In FY 2013, unit cost for Standard Flats decreased from $0.465 to $0.452 (about 3 percent). *Id*.

In the ACD 2012, the Commission noted that the Postal Service was not responsive to its ACD 2010 directive in terms of providing all the required information about the steps it undertook to eliminate intra-class cross subsidy.[8] The Commission requested the information in a number of Chairman Information Requests, and received only part of the requested information. ACD 2012 at 111-112. Again, in FY 2013, the Postal Service failed initially to file all of the required information. Consequently, the information was specifically requested in the Chairman's Information Request No. 2 (CHIR No. 2).

2. CHIR No. 2 response lists actions for more efficient Standard Mail Flats

In response to CHIR No. 2, question 1, the Postal Service described 8 steps that it undertook in FY 2013 to make processing of flats more efficient.[9] It also listed three methodology changes initiated in FY 2013 in accordance with Docket No. RM2013-6 that affected Standard Mail Flats. However, as the Postal Service indicates, the effect of these changes was minimal, and this is consistent with the effect observed last year. As to the contribution shortfall by Standard Mail Flats, it decreased in the two most recent years, a sign of good improvement. In those two recent fiscal years, the Postal Service reduced the shortfall by $272 million (down from $643 million to $380 million), or 41 percent. *Id*. The Postal Service predicts similar progress in FY 2014 when it

[8] The required information is listed in ACD 2010 at 107.

[9] Responses of the United States Postal Service to CHIR No. 2, Question 1. January 23, 2014.

anticipates the contribution shortfall will be reduced to $188 million (a 71 percent reduction from $643 million). *See* Public Representative Initial Comments at 22

The Commission has explained that losses alone do not necessarily require a finding of non-compliance. ACD 2012 at 16. Besides other relevant factors already met by the Postal Service in this proceeding: (1) explaining the circumstances surrounding the shortfall and the reasons for the losses, (2) Postal Service steps to alleviate the shortfall and (3) Postal Service responsiveness to previous Commission suggestions for improvement, a fourth significant factor is the “magnitude and trend of losses” by Standard Mail Flats. *Id*. at 17. The magnitude and trend are clearly moving very favorably in the right direction. Because the Commission concluded in the 2012 ACD that no further remedial action was necessary and in FY 2013 contribution continued to improve and the Postal Service’s actions continued to improve contribution, it must be concluded that the remedial directives in the 2010 ACD do not need revision.

C. Valpak’s Assertion That Standard Mail Flats Are Subsidized by Other Standard Mail Products Is Inaccurate

Valpak asserts Standard Flats are subsidized by other Standard Mail Products:

> 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. Valpak at 5.

Since Standard Flats make no contribution towards the recovery of institutional costs, it is being subsidized by other postal products. However, one cannot conclude that the subsidy is coming solely from other Standard Mail products. The group of products whose revenues are greater than or equal to its stand-alone costs are subsidizing any product or group of products whose revenue(s) are less than its incremental cost. Since the Commission does not have approved incremental or stand alone cost models by product and groups of products, it is not possible to conclude that Standard Flats, or any product with a cost coverage less than 100 percent is being subsidized. However, the Public Representative does support Valpak's basic point; namely that products, such as Standard Flats, are not making a contribution towards the recovery of the Postal Service's institutional costs, and are therefore not satisfying section 3622(c)(2) of the PAEA. The Public Representative would also agree that other mail products with revenues greater than their attributable costs, are bearing an inequitable share of institutional costs.

D. ACMA Would Essentially Combine Some Standard Mail Products

American Catalog Mailers Association (ACMA) takes a position contrary to Valpak and contends Standard Mail Flats rates are too high. ACMA expresses a concern about the "validity of the costs" and that "the level of the rates for Standard Flats is not warranted by the cost coverage."[10] However, while Valpak emphasizes the fact that Standard Flats are under water, ACMA focuses on so called Commercial Flats (which include both Standard Flats and Carrier Route) that are above water. *Id.* at 4-5.

ACMA advances the argument that the mailers who use Standard Flats also use other Standard Flats products, such as High Density and Saturation Flats, whose coverages exceed 100 percent. It argues that Standard Flats is a residual category that cannot be separated from Standard Carrier Route, High-Density and Saturation Flat Mail. ACMA at 4, 8. ACMA concludes that if the coverage of all Standard Mail Flats is considered as a whole, "no subsidy exists." *Id*. 8. ACMA essentially contends that Standard Flat Mail should not be considered a separate product. Following ACMA's argument, the mail classification schedule should be modified. Since there is no doubt that Standard Flats are

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[10] Initial Comments of the American Catalog Mailers Association (ACMA), January 31, 2014 at 4.

subsidized under the current classification, ACMA may petition the Commission to open a rulemaking to modify the mail classification schedule in this area.[11]

II. OTHER CROSS-SUBSIDY COMMENTS

A. First Class---Pitney Bowes' Comments

1. Inequitable cost contributions between Presort and Single-Piece Letters/Cards

Pitney Bowes notes that First-Class Mail Presort Letters/Cards make a unit contribution of 19.1 cents towards the recovery of institutional costs, while Single-Piece First-Class Mail Letters/Cards make a unit contribution of 24.6 cents towards the recovery of institutional costs. Pitney Bowes at 1. It concludes that these inequitable unit contributions (which translate into inequitable cost coverages) "discourages the growth and retention of the most profitable First-Class Mail products," which financially harms the Postal Service. *Id.* 2.

The Public Representative agrees that the contributions mentioned are inefficient. The Postal Service should take steps to diminish inefficient contributions, here, and wherever they appear.

2. Incorrect cost avoidance within Automation Letters and Cards.

Pitney Bowes correctly notes that the Postal Service did not use the Commission-approved methodology for estimating cost avoidances within Automation Letters and Cards. Pitney Bowes at 3. Table 1, below, shows the avoided costs, avoided cost formulas and passthroughs for the relevant AADC Letters and Cards.

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[11] ACMA also claims the Public Representative does not understand its index previously presented to the Commission in other dockets and that the Public Representative's comments in response to ACMA in ACR2012 were erroneous. *Id*. at 11. The Public Representative rejects this characterization. The Commission has never ruled on the merits of ACMA's index. Since the record compiled in previous proceedings regarding the validity and usefulness of ACMA's index has not been supplemented in this proceeding, its relevance remains in doubt.

Table 1

PRC v USPS AADC Passthroughs

Workshared AADC First Class Letters			
USPS Method	**Avoided Cost**	**Passthrough**	**Avoided Cost Formula**
Weighted Average AADC&3-Digit Letters	0.0220	95.5%	= (13.570 -11.558)/100
Automation 5-digit Letters	0.0290	82.8%	= (11.1319 - 8.500)/100
PRC Method			
AADC Letters	0.0200	105.0%	= (13.570 -11.558)/100
Automation 5-digit Letters	0.0260	92.3%	= (11.1319 - 8.500)/100
Workshared AADC First Class Cards			
USPS Method			
Weighted Average AADC&3-Digit Cards	0.013	92.3%	= (8.653 -7.391)/100
Automation 5-digit Cards	0.015	80.0%	= (7.391 - 5.909)/100
PRC Method			
AADC Cards	0.011	209.1%	= (8.6523 -7.555)/100
Automation 5-digit Cards	0.014	85.7%	= (7.343 -5.909)/100

Sources: USPS-FY12-3, "FCM Bulk Letters, Cards," and Dkt. No. R-2013-6, Order 1926 at 160. USPS-FY12-3, FY12.3.Worksharing Discount Table_Final.xls; and USPS-FY13-10, FCM.Ltrs.ACR.xls

Application of the appropriate Commission-approved cost avoidance methodology changes two of four passthroughs from less than 100 percent to over 100 percent. The passthrough for AADC Cards increases more than two-fold, from 92.3 to 209.1 percent. The Public Representative agrees with Pitney Bowes that the Commission should correct the Postal Service's calculations using the approved methodology and require the Postal Service to use the Commission-approved methodology for estimating cost avoidances within Automation Letters in future proceedings.

B. Competitive Products

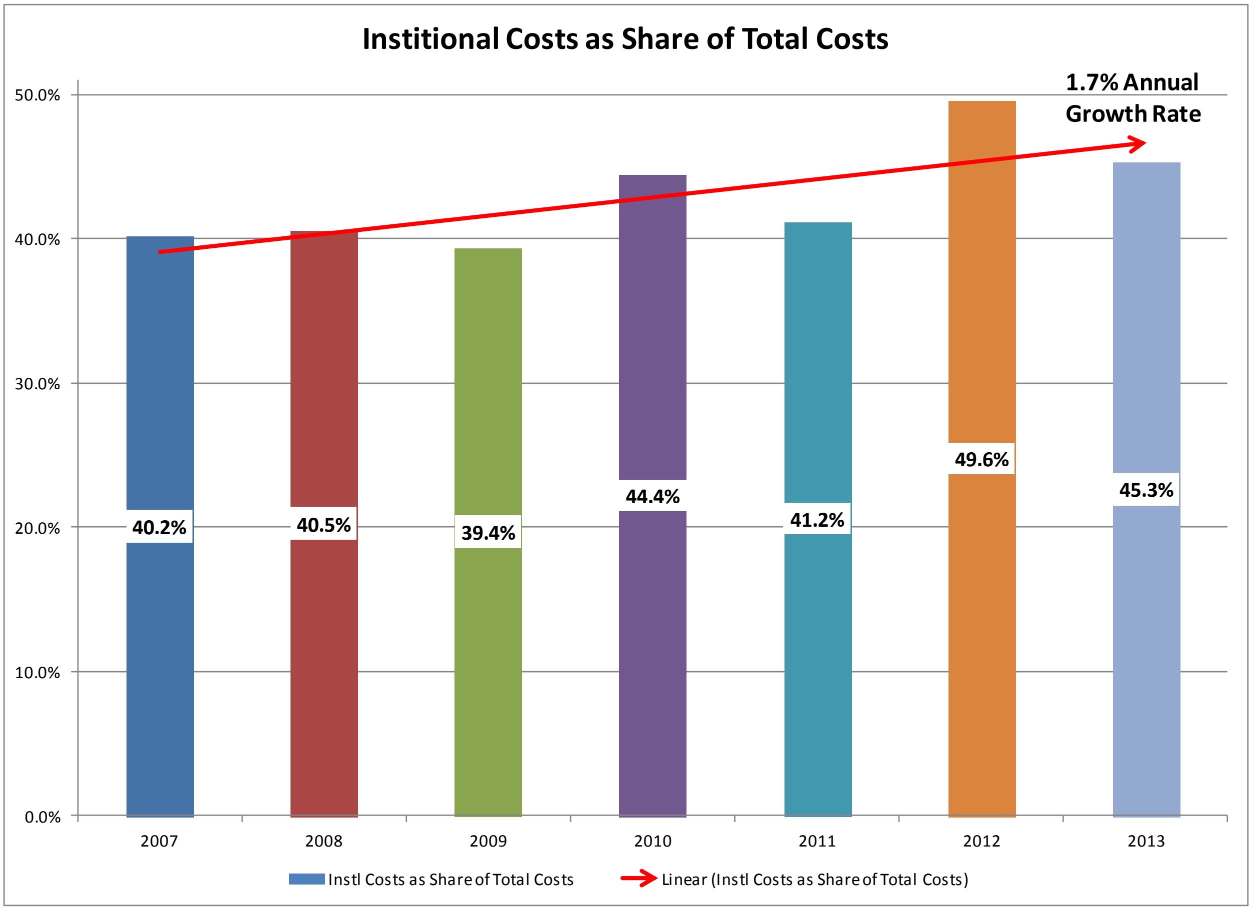
1. Attributable costs as a percentage of total costs are falling

United Parcel Service (UPS) questions whether the Postal Service's Competitive Products account for a fair and equitable share of total postal costs. UPS at 1. UPS makes two basic arguments. First, it contends that total attributable costs have fallen by nearly 11 percentage points since R97-1. *Id*. 2. Second, UPS says the 5.5 percent "sharing requirement," is understated, because "Competitive Products are required to pay only 5.5% of institutional costs, they pay almost 25% of the costs that are attributed."[12] *Id*. 7.

The Public Representative examined UPS' first issue; namely that institutional costs have substantially increased since Docket No. R-97-1 by evaluating whether the increase in the share of institutional costs compared to total accrued costs, has significantly increased since the PAEA legislation. Chart 1 shows annual institutional costs as a share of total accrued costs ("institutional share") since the PAEA was implemented (FY 2007 to FY 2013). The institutional share has annually increased by 1.7 percent from FY 2009 to FY 2013. The annual increase in the institutional share supports UPS's first claim that attributable costs as a percentage of accrued costs are falling.

[12] The sharing requirement means that the Postal Service's contribution must be equal to or greater than 5.5 percent of the Postal Services institutional costs. See 39 U.S.C. 3633(a)(3), and 39 CFR 3015.7(c).

CHART 1
Institutional Costs Under PAEA, FY2007-FY2013



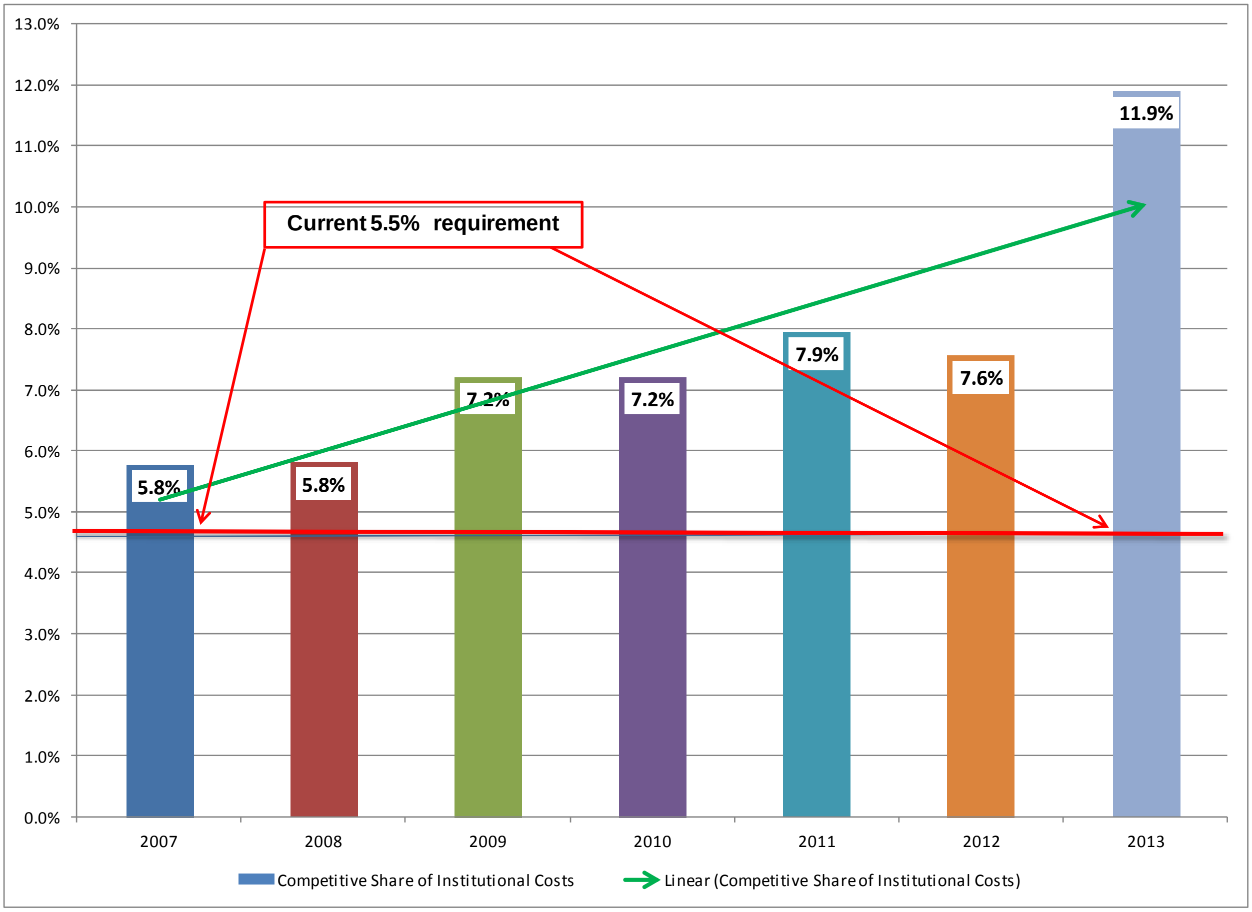
Sources: Costs Components & Segments Reports and Public CRA from USPS Library references filed in ACRs from FY 2007 to FY 2013.

2. The minimum 5.5 percent sharing requirement made by competitive products may be too low.

In order to evaluate UPS' second claim, namely that the 5.5 percent sharing requirement is too low, the Public Representative examined the contribution of competitive products as a share of institutional costs since the PAEA was implemented. Chart 2 shows that there was a significant spike in this ratio in FY 2013, the year in which the transfer of package services from market dominant to competitive categories was completed. There was a 2 percent increase in this ratio, from approximately 5.8

percent in FY 2007 and FY 2008, to an average of 7.5 percent between FY 2009 through FY 2012, and then a notable increase to nearly 12 percent in FY 2013.[13]

Chart 2
Competitive Contribution as a Share of Institutional Costs: FY 2007 to FY 2013



Sources: Costs Components & Segments Reports and Public CRA from USPS Library references filed in ACRs in FY 2007 to FY 2013

Although a doubling of the possible sharing percentage for one year is dramatic, there has been a steady increase in the sharing percentage beginning in FY 2009. The

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[13] The Commission reexamined and affirmed the 5.5 sharing percentage one year ago in Docket No. RM2012-3. The Commission's affirmation was partly based upon data which showed the sharing percentage had not changed much between FY 2007 and FY 2011. But the recent increase in this ratio to nearly 12 percent in FY 2013 suggests that revisiting the Commission's policy may now be appropriate. *See* Order No. 1449 at 20.

simultaneous annual increase in institutional costs as a share of accrued costs and the annual increase in the sharing percentage suggest the Commission should open a rulemaking to consider more appropriate allocations of institutional costs between market-dominant and competitive products and to re-examine the appropriate percentage contribution to institutional costs made by competitive products.

3. Parcel Select covers costs

The Postal Service's initial filing showed that the Parcel Select product did not cover its costs in FY 2013. 2013 ACR at 48. In the initial comments, the Public Representative suggested that the Commission investigate whether Parcel Select's failure to cover costs resulted from an under-reporting of revenue or another data-related anomaly. Public Representative Initial Comments at 47. The Postal Service then filed errata to the 2013 ACR stating that a change allowing Parcel Select to be purchased with PC Postage may have been a cause of under-reported revenue and that the RPW Extract File needed to be updated.[14] The updates to the RPW Extract File, billing determinants, and other related files indicate that Parcel Select did cover its attributable costs in FY 2013. 2013 ACR Errata at 48. The Public Representative is now satisfied that Parcel Select complied with 39 U.S.C. § 3633(a) in FY 2013.

[14] Notice of the United States Postal Service of Revisions to the FY2013 Annual Compliance Report—Errata, February 6, 2014 (2013 ACR Errata) at 1-2.

III. CONCLUSION

The Public Representative respectfully submits the foregoing comments for the Commission's consideration.

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