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

Market Dominant Product Prices Standard Mail PHI Acquisitions, Inc.	Docket No. MC2014-21
Market Dominant Product Prices PHI Acquisitions, Inc. (MC2014-21) Negotiated Service Agreement	Docket No. R2014-6

REPLY COMMENTS OF PHI ACQUISITIONS, INC.

Pursuant to Order No. 2049, PHI Acquisitions, Inc. ("PHI") submits these reply comments to address issues raised by Valpak and the Public Representative in their Initial Comments.[1]

PHI and the Postal Service engaged in extensive negotiations to develop this NSA. The baseline and threshold volumes were established based on the combined expertise of PHI and the Postal Service and their respective experience regarding the effects of discount pricing on mail volume—generally, in the case of the Postal Service, and specifically, with respect to PHI's experience regarding its own volumes over time. PHI submits that not only will this NSA improve the financial position of the Postal

[1] *See* Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Ass'n, Inc. Initial Comments on PHI Acquisitions, Inc. Negotiated Service Agreement (March 27, 2014) ("Valpak Initial Comments"); Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Ass'n, Inc. Supplemental Initial Comments on PHI Acquisitions, Inc. Negotiated Service Agreement (April 10, 2014) ("Valpak Supplemental Comments"); Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Ass'n, Inc. Further Supplemental Initial Comments on PHI Acquisitions, Inc. Negotiated Service Agreement (April 23, 2014) ("Valpak Further Comments"); Public Representative Initial Comments (April 23, 2014) ("PR Comments").

Service by incenting PHI to mail significantly more Carrier Route catalogs than it would have absent the discounts provided by the NSA, but that there are sufficient protections embedded in the NSA to prevent harm to the Postal Service and mailers more generally from any unforeseen changes in the marketplace or PHI's mailing practices.

I. BACKGROUND

PHI is one of the largest multi-channel direct marketers of casual apparel, home décor, personal gifts, and accessories in the U.S. Headquartered in North Billerica, MA, PHI markets to its customers and prospects through a complementary portfolio of 14 catalog brands and 14 internet web sites. Each of PHI's brands serves a unique market niche and targets the same demographic of middle- to upper-middle-income women over the age of 45 who appreciate, want, and use catalogs. Many of PHI's older customers prefer to (or for health or transportation reasons, need to) purchase from their home with a catalog rather than shop for gifts and personal items at retail stores or malls.

PHI's portfolio strategy, proprietary merchandise management software, industry leading marketing analytics and centralized management of 14 brands catering to the same demographic segment is the cornerstone of its success. Profitable growth and stability in a challenging environment has been driven by organic development and acquisitions. The following is a summary of PHI operations and catalog mailings:

- Operational economies of scale and centralized operations provide for superior cost structure.
- Offices are located near Boston and in Maine with three phone centers; currently most fulfillment is handled in a 300,000 sq. ft. warehouse in Massachusetts with expansion plans approved.

- PHI co-mails all its catalogs in PHI exclusive zip streams which allow those mailings to be optimized for postage and circulation planning. PHI uses software developed for its needs to use Add-A-Name and Drop-A-Name logic in final mail prep for its mailings to add names to achieve carrier route and walk-sequence qualification and drop names if they are not economically productive at final 3-5 digit sortation.
- All the catalogs are flats with a common trim size; most are at the piece weight and some are slightly over the piece weight.
- In calendar 2013, PHI mailed more than 200 million catalogs in 36 mail events with greater than 95% of the total volume being Carrier Route or High Density, and all catalogs carried a full-service IMb bar code.
- PHI shipped about 4.2 million packages in 2013, almost all of which are delivered the last mile by the USPS.
- Fifteen percent of PHI orders are received by mail, and PHI catalogs provide order forms and envelopes calling for a customer first class stamp. Additional first class correspondence results from refunds, back-orders and other customer contacts driven by the initial order. New buyers are mailed additional catalogs both from the title the buyer ordered from and from appropriate other PHI titles, resulting in significant future mail volume from incremental buyers.
- Catalogs drive more than 85% of PHI's sales, with the remainder being incremental Web sourced orders.
- PHI follows a disciplined approach to circulation planning based on strict variable cost analysis implemented with proprietary contact models. When the volume-variable cost goes down, PHI mails more. When the variable cost goes up, PHI will mail less, all based on meeting strategic economic targets based on variable contribution. Postage is currently about 60% of its volume-variable catalog cost and therefore has an immense impact on catalog volume.

While PHI is focused on further growth, it determined that significant growth within its existing catalog lines was not feasible at existing postage rates. Accordingly, PHI approached the Postal Service regarding an NSA that would provide the necessary incentives for PHI to maintain and grow its mail volumes, allowing PHI to prospect deeper into its mailing lists.

PHI presented its request for the NSA to the USPS, explaining in multiple meetings how the NSA would provide the necessary incentives for PHI to grow its ECR volumes. The discussions and negotiations with the USPS occurred just as they would with any of PHI's larger vendors with analysis, discussion, compromise, and ultimate agreement. In negotiating the thresholds and incentive rates, PHI relied on its internal data, deep expertise in catalog circulation and postage, and management team with decades of experience negotiating complex business agreements for shipping, paper, printing, and related services. The result of these negotiations was an NSA based on its ability to provide incremental volume in return for a discounted price which PHI believes will be a successful business deal based on honesty and appropriate transparency, clarity, and meaningful benefit to both parties.

II. REPLY TO INITIAL COMMENTS

While the Public Representative professes fundamental support of the NSA, he nevertheless asks for clarifications and additional information to ensure the NSA will result in an improvement of the Postal Service's financial position. PHI is appreciative of Public Representative's support and is absolutely confident that this NSA will improve the net financial position of the USPS and will not cause unreasonable harm to the marketplace. Further, PHI anticipates that this NSA will be made available in a reasonable manner to other similarly situated mailers, and PHI will actively support the extension of its benefits. PHI submits these comments below to help provide some additional information and perspective, to respond to concerns raised by the Public Representative and Valpak in their initial comments, and to further explain the benefits of the NSA to PHI, the Postal Service, and the catalog industry.

A. The PRC-Approved Analysis is Conservative

A common thread running through both Valpak and the Public Representative's comments is a concern that the Postal Service has not applied the proper, Commission-approved analysis to demonstrate that the NSA will improve the net financial position of the Postal Service. *See, e.g.*, PR Comments at 3-4; Valpak Initial Comments at 5. These concerns should be resolved by the Postal Service's response to CHIR No. 2, Question 1 and CHIR No. 3, Question 1, which demonstrate that even using the Commission-approved Panzar analysis and elasticity figures for ECR (Commercial), the NSA will result in a net benefit to the Postal Service over the first year. The current NSA is therefore unlike the Discover NSA, which the Commission recognized from the outset was unlikely to result in positive contribution using the Commission's preferred analysis. *See* Order No. 694, Order Adding Discover Financial Services 1 Negotiated Service Agreement to the Market Dominat Product List, Docket Nos. MC2011-9 and R2011-3 at 14-15. PHI submits that the benefit realized by the Postal Service will be even greater than the Panzar analysis suggests.

The Public Representative comments that there were three sets of analyses presented by the Postal Service. PR Comments at 3. The Public Representative is correct; however, all three analyses are "correct" based on their starting assumptions. The first was based on the postal rates before exigency and evaluated the financial impact of the NSA according to the Postal Service's forecast of PHI's likely mailing behavior with and without the discounts. As explained in the USPS response to CHIR No. 1 Question 10.b., in developing this analysis, USPS relied on the information regarding

PHI's historical mailing behavior gleaned during extensive negotiations with PHI during the development of the NSA as well as USPS knowledge of catalog industry economics and expected future economic conditions. PHI believes this analysis accurately represents how PHI would react to the discounts provided by the NSA, in line with PHI's circulation-planning process and historic reaction to changes in postage prices, including the Summer Sales. Put simply, the discounts provided by the NSA will allow PHI to mail much deeper into its lists and prospect for more new customers than PHI would absent the NSA. The Postal Service's initial analysis, relying on knowledge of PHI's internal modeling as well as the general operation of the catalog industry, accurately depicts PHI's likely before-rates and incented volumes (absent an exigent price increase) and provides a reasonable forecast of the likely financial benefit of the NSA to the Postal Service.

The Postal Service's second analysis simply updates the first analysis to account for the effect of the exigent price increase. The adjustments are made according to Section III.D of the NSA and, as required by the agreement, rely on PHI's actual mail volumes and the postage PHI would have paid if the exigent increase had been in effect.

PHI believes that these analyses, because they account for PHI's particular circumstances, provide the best information on the record regarding the likely financial impact of the NSA. Nevertheless, PHI understands that the Commission has historically relied on the Panzar methodology to evaluate the financial impact of NSAs, and therefore requested that the USPS evaluate the NSA according to this methodology. As shown by the Postal Service's response to CHIR No. 3, Question 1, this analysis demonstrates that the NSA will have a positive financial impact even under the Panzar methodology's more conservative assumptions. *See also* PR Comments at 4 (acknowledging that use of the Commission-approved methodology estimates "a positive net financial benefit of $1.5 million in year 1.") As the Public Representative acknowledges, the Panzar methodology appropriately shows only the first year impact. PR Comments at 4 ("Due to the complexity of the contract terms, it is impractical to estimate net financial impact beyond the first contract year.") Although USPS does not use the Panzar methodology to show the estimated net financial impact through all years of the NSA, this approach stems from limitations of the Panzar approach and should not be blamed on the necessary terms of the Agreement. Specifically, it is difficult to discern how to apply the Panzar equation to the out years of the agreement when the baseline and threshold volumes that will exist in those years cannot be definitively established at this time. But in drafting an NSA, there is no requirement to create terms that fit neatly into a complex and limited economic formula. Where the Panzar analysis can be applied, it demonstrates that the agreement will provide the Postal Service with a net financial benefit.

Moreover, the Panzar analysis provided by the Postal Service uses the subclass elasticity of -0.89. PHI believes that the analysis therefore provides a conservative estimate of the volume the discounts will induce. Although the Postal Service did not calculate a mailer-specific elasticity in this case, PHI's experience is that changes in the cost of postage have a much greater impact on its mailing volumes than the subclass elasticity used in the Panzar analysis would suggest.

Valpak's criticism of the Panzar analyses performed by the Postal Service is not credible. While the chart shown on page 2 of Valpak's Further Comments comparing the Postal Service's initial and corrected Panzar analysis is correct, Valpak completely misinterprets the meaning of the figures. The aspect of the chart that Valpak claims "make[s] no sense"—that the total value of the NSA to the Postal Service increases in response to a larger marginal discount—in fact is completely sensible. Valpak Further Comments at 2. First, this result occurs not because of some chicanery on the part of the Postal Service, but simply by updating the Panzar analysis with the correct information. As the Postal Service acknowledged in response to CHIR No. 3, Question 1, it used the incorrect figures for the marginal discount and rebates paid in its initial analysis. Once the correct figures were substituted into the model, the analysis resulted in an increased benefit to the Postal Service. Second, this result makes intuitive sense. The higher marginal discount would result in the payment of more rebates. With a constant elasticity, however, the higher discount would also result in more volume being credited to the effect of the discount, rather than before-rates volume. Thus, the total contribution to the Postal Service from the same expected NSA volume would increase.

Finally, none of the analyses above account for the additional benefits the Postal Service will receive as a result of the NSA. While not quantified in this case, it is indisputable that increased catalog mailings generate additional mail of other classes through orders placed by mail, fulfillment, customer correspondence, and returns.

Section V.D. of the agreement specifically provides the Postal Service with the right to terminate the agreement if less than 80% of PHI's residential package volume is delivered to residences by the Postal Service. Further, because the discounts are available only for Carrier Route Flats, the NSA encourages economies of scale and scope which will benefit the overall preparation of Flats mail. And as described further below in discussion of the clauses of the NSA governing future PHI acquisitions, the NSA will likely cause significant amounts of mail to convert to Carrier Route, moving mail into a more profitable category. In sum, PHI is confident that, by any metric, the NSA will have a positive financial impact on the Postal Service and thus operate to the benefit of all mailers.

B. The Public Representative's Concerns about Recent Increases in PHI Volume are Unwarranted

The Public Representative has raised concerns about PHI's recent volume history, suggesting that this history indicates that the before-rates volume forecasts prepared by the Postal Service might be inaccurate. *See* PR Comments at 8-12[2] While the NSA is likely to result in a positive financial impact for the Postal Service even if the Postal Service's volume forecasts are not accurate, there are several factors at play in the cited volume increase which should assuage any concerns that the Postal Service's projections are significantly off the mark. First, it is important to note that mailings made in the first quarter of FY2014 were planned and executed before the exigent price increase took effect. Additionally, going forward, PHI has limited ability to cut circulation on mailings in FY 2014 going forward that were planned prior to the implementation of exigent prices. While the exigent rate increase was still pending at the Commission, PHI planned mailings accounting only for an estimate of the CPI increase. When exigency rates were enacted, PHI had already printed the books for mailings in February 2014, bought paper for books to mail in March, and placed orders for inventory for books that would mail in March, April and May for some titles and June, July, and August for other titles. As was well noted by many catalogers in the first Summer Sale of 2009, it takes 6-9 months for a catalog company to react to significant variable cost changes to mail primarily because of inventory and other material commitments. PHI will not have fully reacted to the exigency rate change until the fall of 2014. Thus, the volumes cited by the Public Representative do not fully reflect the impact of the exigent rate increase.

Additionally, some of this volume increase is due to shifts in the timing of mail entry volume—that is, volume that was instead mailed in the fourth quarter in FY 2012, instead of being mailed in Q4 in FY2013, was mailed in the first quarter of FY2014 due to routine shifts in mailing schedules of just a few days, done as the normal course of business. Just as Thanksgiving "migrates" away from Christmas year-after-year, then catches up every few years, mailers move mail dates periodically to stay in the prime selling seasons before Christmas. Similarly, PHI shifted some campaigns about a week which were originally slated for 2Q FY2014 to 1Q FY2014 for business reasons

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[2] . CHIR No. 4, issued on April 29, 2014, seeks additional information on this subject. PHI is in the process of preparing a detailed response to these questions and a response will supplement the information and explanation set forth in these comments.

unrelated to the NSA. Combined, these planning and timing adjustments present the appearance of larger changes in volume than actually occurred.

Regardless, the Postal Service's volume forecasts were made with the best information available at the time the NSA was negotiated. If volume forecasts are to be adjusted, and NSAs re-evaluated, with every quarterly shift in volume, mailers will never engage in the difficult process of negotiating an NSA. The uncertainty will be too great. Instead, the Commission should recognize that the Postal Service used the best available information and evaluated the agreement on that basis.

C. Exigent Rate Rescission

Both Valpak and the Public Representative have raised the issue of how baselines and thresholds will be adjusted in the event the exigent price increase is rescinded, as directed in Commission Order No. 1926, before the term of the NSA expires. Valpak Further Comments at 3; PR Comments at 11. In negotiating the NSA, the possibility of a temporary exigent increase that would expire during the term of the agreement was not contemplated. Regardless, PHI expects that if exigency were terminated, the calculation of the revision to the baselines would be done just as it was when the exigency was put in place, and the functional result would leave the then amended Agreement with the same relative impact and value as before exigency and after exigency. That is the purpose and design of the baseline adjustment. PHI does not believe that there is anything to be learned from doing that theoretical exercise at this time. One can see the results by simply looking at the baselines before and after exigency and understanding how they would be resolved to the new higher baselines (arriving back to essentially the initial baselines) after exigency is terminated. Of course, the adjustments would be performed on the existing baseline at the time of termination of the exigency surcharge and the volumes from the appropriate prior 4 quarters (rather than baselines and volumes on which the initial exigency adjustment was performed), which makes it difficult to calculate today the precise level the baselines would revert to when the exigency expires.

D. A Discount Cap Is Unnecessary

The Public Representative recommends that the Commission impose a cap on the discounts available to PHI. PR Comments at 14. PHI objects to this recommendation for several reasons. First, the calculation of the cap and its impact on thresholds, acquisitions, and divestiture would make the NSA extremely complex. Second, since the discounts are on incremental Carrier Route mail that has significant contribution for the Postal Service, it would put a limit on the upside of the deal for the Postal Service. In the same way, a cap would limit the upside for PHI. Finally, a discount cap is not necessary given way this agreement will in fact work. The NSA results in positive contribution for the Postal Service at all discount levels; if it does not, the Postal Service has the right to terminate the agreement under section V.D. Accordingly, the idea of a discount cap was firmly rejected by both parties in negotiating the agreement as too complex and unnecessary.

The Public Representative further argues that a discount cap is necessary to address the effects of acquisitions by PHI. PR Comments at 14. The Public Representative's concerns are unwarranted. Section IV.F. of the agreement provides for adjustments to the baseline volumes and volume thresholds tied to the volume mailed by any company PHI acquires, ensuring that PHI cannot achieve discounts solely through acquisitions. Moreover, as the Public Representative acknowledges, the catalog industry averages only 70.5% Carrier Route mail. PR Comments at 14. Thus, any company acquired by PHI would be expected to have Carrier Route volume (i.e., discount-eligible volume) of only 70.5% of its Standard Mail Flats volume. Yet the agreement provides for the incorporation of 80% of the acquired company's Standard Mail Flats volume into the baselines and thresholds. To obtain discounts on the volume resulting from acquisitions, PHI will likely need to increase the Carrier Route volume tied to the acquired company, thus providing the Postal Service with more profitable mail.

Additionally, while the agreement calls for adjustments to the baselines to be established within 30 days of an acquisition, in practice, it has often taken PHI much longer to fully incorporate an acquired company's volume into its mail streams. For example, PHI's last acquisition closed on January 1, 2013, yet PHI could not move the printing/mailing to its mail stream until April. PHI executed six mailings at the 65% Carrier Route level while, if NSA had been in place, the volume threshold would have gone up by 80% of that title's volume. PHI therefore believes the 80% volume addition for acquisitions represents a fair compromise that protects both parties to the NSA and obviates the need for any discount cap tied to acquisitions.

E. The NSA Properly Apportions Risk Arising from Volume Changes Resulting from Acquisitions and Divestitures between the Parties

The Public Representative separately recommends that the Commission require the Postal Service to provide an analysis of the historical impact of acquisitions and divestitures on PHI's volume. PR Comments at 15. While PHI is doubtful that the Commission would glean much relevant information by looking back over PHI's acquisitions history, and while PHI believes the NSA fairly apportions any risk associated with volume resulting from acquisitions, an examination of PHI's last two acquisitions provides examples of the benefits and impact to the USPS such acquisitions would have under the NSA.

PHI made its most recent acquisition in January of 2013. The acquisition target was a well-developed brand with a good management team with limited resources to manage marketing. In the first 12 months of ownership, PHI *reduced* the circulation volume of the brand by 4% to eliminate ineffective circulation while *increasing* the Carrier Route and High Density percentage of the mail from 65% to 95%. If the NSA had been in place at the time of acquisition, the USPS would have gained 30% in profitable mail volume on that title (the move of 30% from 3-5 digit to CR/HD). As the volume threshold would have increased by 80% of the brand's volume, PHI would have benefited from a discount on the other 15% (95% CR – 80% threshold). This is an example of both parties sharing roughly equally in the benefit of an acquisition.

PHI's previous acquisition closed in August of 2010. This title was a more typical acquisition for PHI because it had been losing money, was owned by a much larger corporation that had little experience in catalog marketing, and was closed down. They were not mailing and had no intention to mail again and looked for a buyer. The last full year of operation, they mailed 4.8 million catalogs. PHI acquired the assets which included the name, house file, mail history and merchandise data. The acquisition occurred too late in August to mail more than a test book that holiday season, but in the first full year of operation, 2011, PHI mailed 16.1 million catalogs of that title. In this case, PHI would have benefited from the small increase in the threshold, but the USPS would have added almost 16 million Carrier Route and High Density mail pieces that they would not have had at all if PHI did not make the acquisition. Again, both parties had significant benefits from the acquisition.

While PHI has never divested a title, it was important to have provisions regarding divestment in the Agreement as divestment could have a major impact on PHI's mail volume that should be reflected in the thresholds.

F. The NSA Will Not Cause Unreasonable Harm to the Marketplace

Although the Public Representative and Valpak claim that the Postal Service has not demonstrated that the NSA will not cause unreasonable harm to the marketplace, the Postal Service has in fact made the required showing. See PR Comments at 15; Valpak Supplemental Comments at 3. As the Commission stated in approving the Valassis NSA, the relevant concern for the Commission is the effect of the NSA "on competition as a whole, rather than the impact on individual competitors." Order No. 1448, Valassis NSA, Docket Nos. MC2012-4 and R2012-8 at 26. The Public Representative's and Valpak's comments, by contrast, focus exclusively on harm to individual competitors.

The Commission further explained in Order No. 1448 that "as long as the Postal Service is not pricing its products below costs to drive its competitors out of business, it is not creating an unreasonable level of harm in the marketplace." *Id.* at 27. The Postal Service has demonstrated that the NSA will result in positive contribution to fixed costs; in fact, the Postal Service may terminate the agreement if it does not. There is therefore no question that the Postal Service is not pricing its products below cost, and accordingly no question that the NSA will not cause unreasonable harm to the marketplace. The District of Columbia upheld the Commission's reasoning on this issue in Order No. 1448, and there is no reason to revisit those holdings in this case. *See Newspaper Ass'n of*

America v. Postal Regulatory Commission, Case No. 12-1367, slip op. at 12-14 (Nov. 15, 2013).

Further, the Public Representative (and ValPak) erects a standard of proof—that the Postal Service must "affirmatively" prove the absence of harm to the "marketplace"--- which goes beyond the requirements of the PAEA and the Commission determination in the Valassis Order. Indeed were the Commission to accept this argument it would create an irrefutable presumption that all NSAs cause competitive harm because affirmative proof of the absence of harm is virtually impossible.

Under conventional competitive analysis, the first task is to define the relevant market, and this is done by identifying entities that offer products that are close substitutes for the PHI products. The fact that there may be a differential between the postage rates paid by PHI under the NSA and the rates that are paid by competitors is not indicative of harm to the marketplace; the assessment of harm to the marketplace must be made on the basis of the effect of the arrangement on the products sold, precisely because competition is designed to benefit consumers and not individual competitors. There is simply no way to perform that kind of analysis in the present setting since there are literally thousands of companies – not all of whom use the mail -- that sell products that are arguably close substitutes to PHI products. Thus it is impossible to "affirmatively" define the relevant market for purposes of the analysis that the Public Representative demands.

The second task in the conventional competition analysis is to determine whether the arrangement will substantially diminish competition—that is whether the arrangement will allow PHI to underprice its competitors in the sale of its products, thereby increasing its market share to unacceptable levels. Even if it were arbitrarily determined that the relevant market is confined to direct mail or to “catalogs” (a term that is not self – defining even for Postal purposes which treats catalogs as flats), it is equally impossible to “affirmatively” measure the effect of the NSA on the product prices charged by either PHI or its competitors: the marketing costs (postage or other advertising expenses in other media) may not be the exclusive or even the primary driver of the product prices charged. Therefore, the attempt by the Public Representative to shift the burden of proof as to harm must be rejected. Plainly, PHI’s market share is and will remain only a very small fraction of the total universe however the relevant market might be defined and the absence of predatory, below cost pricing under this NSA is more than sufficient to prove the absence of harm to the marketplace under the standards of the PAEA. See 39 USC§403(c).

Maybe the most important outcome for the catalog market is that this NSA will prove that it is possible for catalogers to work with the USPS on a business agreement and that the USPS is approachable. Approval of the NSA should encourage other catalogers to either create their own NSAs or functionally equivalent NSAs. Additionally, implementation of this NSA will provide information to the USPS about this vertical market that will help them think about and implement other incentive programs for catalogs. Catalogs are an important part of our economy, the USPS business, and an important part of American culture. PHI expects this NSA will be important in sparking new focus and potential growth in cataloging.

Finally, PHI notes that no competing catalog companies have filed any objections or comments opposing this NSA, despite general awareness of the NSA within the industry. Accordingly, there is no evidence on the record before the Commission that the NSA will cause harm to competitors of PHI.

III. CONCLUSION

PHI is confident that this NSA will provide benefits to the Postal Service and the catalog industry far beyond additional contribution resulting from increasing PHI's increased Carrier Route Flats volume. Yet even without these benefits, the evidence of record plainly demonstrates that the NSA will have a positive net financial impact on the Postal Service, and no party has presented credible evidence to the contrary. Accordingly, PHI respectfully requests that the Commission approve the NSA.

Respectfully submitted,

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