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

ANNUAL COMPLIANCE REPORT, 2014	Docket No. ACR2014

COMMENTS OF
THE NATIONAL POSTAL POLICY COUNCIL
(February 2, 2015)

The National Postal Policy Council ("NPPC")[1] respectfully submits these comments on the Postal Service's Annual Compliance Report for Fiscal Year 2014 ("*ACR*"), filed December 29, 2014.

The annual compliance review provides an opportunity for the Postal Service and Commission to identify and begin to address some of the issues affecting First-Class Presort Mail. From the perspective of NPPC's First-Class business mailer members, the following issues appear salient:

– First-Class Automation and Presort Letters and Cards once again paid an exorbitant cost coverage -- nearly 100 percent higher than the average for First-Class Mail -- and a significantly larger unit contribution than more costly Single-Piece mail, perpetuating a long-standing pattern. In light of this, it is appropriate to question whether the rate schedule continues to be just and reasonable, as required by Section 3622(b)(8) of the Postal Accountability and Enhancements Act ("PAEA"), or satisfies other objectives set forth in Section 3622(b).

– The estimates of costs avoided in First-Class Mail due to worksharing continue to vary unpredictably from year to year. Consequently, the

1 The National Postal Policy Council is an association of large business users of letter mail, primarily Bulk First-Class Mail using the Automation rate category, with member companies from the telecommunications, banking and financial services, insurance, and mail services industries. Comprised of 39 of the largest customers of the Postal Service with aggregated mailings of nearly 30 billion pieces and pivotal suppliers, NPPC supports a robust postal system as a key to its members' business success and to the health of the economy generally.

Postal Service's practice of pragmatically adjusting discounts while taking into account vital business factors is reasonable and satisfies Section 3622(e); and

– The Commission should consider reducing the price cap applicable to First-Class Mail to offset (1) the recent reductions in service quality – such as the slower service standards resulting from Network Rationalization; and (2) the increased cost of using the mail resulting from the Postal Service's shifting costs to mailers.

I. THE PERPETUALLY EXCESSIVE COST COVERAGE OF FIRST-CLASS PRESORT LETTERS AND CARDS VIOLATES SECTION 3622(b)

The *ACR* reports that the cost coverage paid by First-Class Presort Letters and Cards in FY2014 was an extraordinary 320.16 percent – the highest ever for Presort mail since enactment of the PAEA and nearly 100 percent higher than for the entire First-Class Mail class.[2] That cost coverage was, by a substantial margin, the highest of any significant mail product (exceeded only by that of Every Door Direct Mail). For Presort Letters -- easily the largest and most important product in the class – the cost coverage was 320.84 percent; for Cards, 303.36 percent.[3] Both coverages nearly double the market-dominant system average of 184.31 percent.[4]

Unfortunately, the extraordinarily high cost coverage for First-Class Presort mail is not a one-year aberration. Instead, it follows a persistent pattern over many years that has harmed both business mailers and the long-term financial interest of the Postal Service.

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2 *ACR* at 7.

3 *ACR*, USPS-FY14-2, Public FY14CRA-4.xls.

4 *Id*.

In each annual compliance review proceeding under the PAEA, NPPC has pointed out that First-Class Presort Mail has paid extremely high per-piece contributions to institutional costs and excessive cost coverages for many years. This pattern is quite evident from the following table:

First-Class Presort Letters and Cards

	Attributable Cost (cents)	**Average Price (cents)**	**Unit Contribution (cents)**	**Cost Coverage (%)**	**System Cost Coverage (%)**
FY2014	11.8	37.8	26.0	320.16	184.31[5]
FY2013[6]	11.67	36.30	24.63	311.1	165.7
FY2012[7]	12.15	35.64	23.49	293.3	160.8
FY2011[8]	11.65	34.982	23.332	300.3	159.1
FY2010[9]	11.679	34.739	23.060	297.4	161.1
FY2009[10]	11.704	34.152	22.448	291.8	164.5
FY2008[11]	11.023	33.023	22.000	299.6	164.0

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5 Market-dominant products only. USPS-LR14-1 (Public FY14CRS.xls).

6 PRC, *Financial Analysis 2013: Analysis of United States Postal Service Financial Results and 10-K Statement for Fiscal Year 2013*, at 43-44 App. A (revised Apr. 20, 2014).

7 PRC, *Annual Compliance Determination Fiscal Year 2012*, at Tables VII-1 & D-1 (Mar. 28, 2013).

8 PRC, *Annual Compliance Determination, Fiscal Year 2011,* at 96 Table VII-1 (Mar. 28, 2012).

9 PRC *Annual Compliance Determination, Fiscal Year 2010,* at 84 Table VII-1 (Mar. 29, 2011, as corrected Apr. 8, 2011).

10 PRC, *Annual Compliance Determination, Fiscal Year 2009,* at Tables IV-5 & B-1 (Mar. 29, 2010).

11 PRC, *Annual Compliance Determination, Fiscal Year 2008,* at Table III-2 (Mar. 30, 2009) ("*FY08 ACD*").

Looking at only First-Class Mail, the average cost coverage for all First-Class Mail in FY2013 was 210.4 percent; in FY2009, the average for all First-Class Mail was 199.6 percent.

The pattern is unvarying and unmistakable. First-Class Presort Letters and Cards, year after year, have paid a far higher cost coverage than any other mail product. In addition, First-Class Presort mail has, throughout this period, made larger contributions to institutional costs on both a per-piece AND aggregate basis than Single-Piece mail or any other mail product.

To some extent this is a relic from pricing decisions that predated the enactment of the PAEA, made in an era when Presort mail was considered just a subset of Single-Piece mail rather than an independent product with significantly different cost and demand characteristics. Yet the current ratemaking system and rate structure have done nothing to alleviate the harms caused by perpetuating archaic past perceptions, or to prevent the Postal Service from effectively treating Presort mail as little other than a piggybank to raid until its volume pales into inconsequence.

Section 3622(b)(8) of the PAEA prescribes, as an objective of the system for regulating market-dominant rates, the establishment and maintenance of “a just and reasonable schedule for rates.” And while subsection (b)(8) specifically allows unequal rate changes within a class, it does not authorize systematic, consistent, and persistent discrimination against certain products over a multiyear period.

In its comments on the FY2010 ACR and again on the FY2012 ACR, NPPC suggested that the recurring far-above average contributions extracted from Presort mail on both a per-piece and aggregated basis – little different in those years from what persisted in FY2014 – cast doubt on whether the rate structure was "just and reasonable" as required by Section 3622(b)(8). In 2010, the Commission acknowledged NPPC's concern, but essentially treated it as premature:

> *At this time* the Commission does not find that the cost coverage for Presort First-Class Letters violates section 3622(b)(8). The Commission will continue to monitor the cost coverages of products to ensure compliance with the Act. NPPC has not demonstrated that prices are not just and reasonable.

ACD FY2010 at 85 (emphasis supplied).

In its comments on the ACR for FY2012, NPPC reiterated that the excessive and unremitting high cost coverage of Presort mail was not just and reasonable, and observed that the resulting high prices contributed to the steady volume decline of that product. *Comments of NPPC*, Docket No. ACR2012 at 2-4. The Commission's response in that proceeding was simply: "Market dominant mailers have the protection of a price cap to shield them from excessive price increases." *ACD2012* at 82. While NPPC agrees that a price cap helps to restrain new price increases,[12] it does nothing about reducing cost coverages long built into the system and still being exploited.

The Commission also suggested that the systematic overpricing of Presort mail was somehow offset by marginal changes of use to limited numbers of mailers: "the Postal Service has often used its pricing flexibility in ways that benefit mailers of the

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[12] The Postal Service's notice in Docket No. R2014-5 shows how the price cap helps only partially; because the cap applies to classwide increases, Presort mail is set to receive considerably higher than inflation average increases while Single-Piece mail receives virtually no increase.

Presort Letters/Postcards product," citing the elimination of the second-ounce charge for Presort letters up to 2 ounces and the 2012 Mobile Commerce and Personalization Program promotional discount for two-dimensional mobile barcodes. *Id*. Although NPPC members appreciate the elimination of the second-ounce charge for some mailings and the occasional temporary discount, such tinkering around the periphery does not offset the central problem. Experience over the past six years has shown that the price cap does nothing to prevent the pattern of imposing the highest increases on Presort mail.

NPPC is aware that objectives other than subsection (b)(8) apply to market-dominant rate regulation, but those are not being met either. For example, the continuous overpricing of Presort mail suggests that it is receiving little of the pricing flexibility objective cited in the FY2012 ACD. Instead of pricing flexibility, for Presort mail the Postal Service appears to have adopted a pattern of pricing rigidity – the highest increases, and the highest cost coverages, invariably apply to its most profitable product: Presort Letters and Cards.

One can also question whether the Postal Service's current pricing practices satisfy objective 1 ("maximize incentives to reduce costs and increase efficiency") or objective 5 ("assure adequate revenues"). Furthermore, as discussed in Section III below, the price cap has not prevented the Postal Service from degrading service or shifting costs to mailers.

In particular, that Automation 5-Digit Letters repeatedly receive the largest increases and lowest workshare discount pass-throughs violates the goal of maximizing incentives to reduce costs. Indeed, the Postal Service could take a major step towards moderating the overall cost coverages of Presort Letters simply by passing through 100 percent of the costs avoided at the 5-Digit Presort Letter level.

Nor is it obvious that the current system meets the Section 3622(b)(5) standard of assuring adequate revenues to maintain the Service's financial stability. Mail volume generally, and Presort mail volume in particular, has steadily declined during this period of far-above-average cost coverages. Faced with high prices and consistently unfavorable pricing treatment, can there be any surprise that Presort mail volumes have declined even during an economic recovery? In FY2009 – the year the recent recession ended – First-Class Presort mail volume was 48,235,220,000 pieces. *ACD FY2009* at 29, Table IV-5. Five more years of overpricing has substantially contributed to reducing Presort mail volume to only some 40,193,309,000, despite the end of the recession in 2009 and five subsequent years of economic growth. *See USPS-LR2014-4* Billing Determinants. Price plays a key role in determining whether to make electronic or other substitutions, and in spurring efforts to end state-level legislative mandates to deliver certain communications via paper, notably in the insurance segment of First-Class Mail. Ending such mandates, as has now occurred in a growing number of states, materially expands the pool of First-Class Mail from which to make such substitutions.[13]

[13] Internal insurance industry estimates provided to NPPC now put the number of states permitting electronic identity cards as proof of insurance at nearly 40, with 15 states permitting the posting of policy contracts online, and at least four permitting cancellation/renewal notices to be emailed. The industry continues to work with states to take flexible approaches to communications and to allow electronic options to be considered valid.

In 2011, NPPC commented that the Postal Service seemed to be following a strategy of extracting the maximum possible revenue from the diminishing number of First-Class Presort pieces in the mailstream, rather than pricing its most profitable product in a manner that encourages volume stability and growth. *See NPPC Comments*, Docket No. ACR2010, at 3-4. Nothing seems to have changed. While the Postal Service publicly laments the decline of its largest and most profitable product, not once has it tried to stabilize volumes or encourage mail growth by reducing Presort rates. It should come as no surprise that charging the largest volume product excessive rates year after year results in declining volumes year after year as businesses look for less costly alternatives.

A consistent history of imposing the highest cost coverages and largest percentage increases on a product that regularly far exceeds the system average contravenes a number of the objectives of the current rate system. The time has come for the Commission to evaluate whether the Postal Service's fixation on giving the highest cost coverages to Presort Letters and Cards, year after year after year, is consistent with subsections 3622(b)(1), (4), (5) and (8) of the PAEA.

II. THE COMMISSION SHOULD NOT ORDER ANY CHANGES IN FIRST-CLASS MAIL WORKSHARING DISCOUNTS

The Postal Service identifies four First-Class Presort Letter/Cards and three Automation Flats worksharing discounts in effect in FY14 that exceed the costs that it recently estimated were avoided during that year. *ACR* at 10. The Commission should continue to assess compliance with Section 3622(e) over time in recognition of the erratic nature of the estimates of the costs avoided due to worksharing in First-Class Mail and the Postal Service's pragmatic approach to adjusting discounts.

The Postal Service, the Commission, and mailers have sufficient experience with the ACR process to know that estimates of costs avoided for the same worksharing activity can vary – sometimes widely -- from year to year. FY2014 was no different. The Postal Service's *ACR* summarizes considerable whipsawing in costs avoided estimates (*ACR* at 11-14). For example, the costs avoided by preparing AADC Automation Letters dropped almost 30 percent from FY2013 (2.9 cents) to FY2014 (2.0 cents). *ACR* at 10. For 3-Digit Automation Flats, the avoided costs have fluctuated from 5.7 cents (FY2012) to 3.6 cents (FY2013), and more recently back up to 4 cents (FY2014). *ACR* at 13.

These changes in the estimated costs avoided eventually lead to corresponding changes in the discounts. NPPC understands the statutory requirement as well as the economic benefits of the Efficient Component Pricing that underpins the statute, but such fluctuations undermine the predictability in rates that is vital for business planning.

It is true that there is "no statutory exception to address the structural lag between the estimate of new cost avoidances and pre-existing discounts." *ACR* at 13. However, it is equally true that there is no evidence that an estimate of avoided costs for a particular worksharing activity in one fiscal year will be accurate for the next fiscal year. In other words, there is no evidence that any First-Class worksharing discount going forward will exceed 100 percent of the costs avoided that will be estimated in this proceeding. In fact, history suggests the avoided costs may differ materially from the estimate in the *ACR*. This supports the Commission's practice of being cautious when making judgments about discount levels.

In this proceeding, for six of the seven worksharing discounts for Presort Letters and Cards identified by the Postal Service as exceeding the estimated costs avoided in FY2014 -- AADC Automation Letters, Automation Mixed AADC Cards, Automation AADC Cards, Automation 5-Digit Cards, Automation AADC Flats, and 3-Digit Automation Flats – the Postal Service has already noticed, in Docket No. R2015-4, reductions in the discounts to levels that equal 100 percent pass-throughs of the estimated costs avoided contained in the *ACR* for all but one. These new rates are scheduled to take effect on April 26. Consequently, there is no reason for the Commission to order any different action.

Only for 5-Digit Automation Flats will the new discount exceed 100 percent. NPPC will address the new discount in its comments in Docket No. R2015-4. For purposes of this proceeding, it is evident that the discount exceeds 100 percent because of an unexpected change in the estimate of avoided costs. As the Postal Service summarizes (ACR at 14), the avoided costs for this discount were 17.4 cents in FY2010, 18.8 cents in FY2011, 14.3 cents (!) in FY2012, and 14.1 cents in FY2013. The latest estimate, for FY2014, is 15.2 cents.

This history of gyrating estimated costs avoided demands a cautious approach. Furthermore, given the importance of the 5-Digit Automation Flats discount in the Presort discount tree, the Postal Service's approach of taking business and other considerations into account in pricing over time is appropriate. Accordingly, the Commission should continue to discharge its oversight responsibilities by deferring to the Postal Service's pragmatic approach to addressing this discount in a manner that balances business and mailer concerns.

III. THE COMMISSION SHOULD CONSIDER ADJUSTING THE PRICE CAP TO OFFSET THE COSTS OF SERVICE REDUCTIONS AS WELL AS COSTS THAT THE POSTAL SERVICE HAS SHIFTED ONTO CUSTOMERS

In recent years, the Postal Service has engaged in a number of actions – some prominent and attracting political attention, others buried in the minutia of mailing regulations – that cumulatively have devalued the quality and attractiveness of First-Class Presort mail. It is well understood in regulatory economics that a regulated entity may seek to evade a price cap by reducing the quality of service and shifting costs onto its customers. It is apparent after eight years under a price cap that the Postal Service has done, and is doing, both. It is time for the Commission to address the implications of the Postal Service's actions on the rate cap for First-Class Mail.

The Postal Service indisputably reduced service as a consequence of the Network Rationalization plan,[14] as the Commission understood during its review in Dockets Nos. N2012-1 and N2012-2. Areas that formerly received overnight delivery slipped to two-day delivery (unless business mailers take new and costly steps to reconfigure their operations) and areas that formerly received two-day service received three-day service. These service changes allowed the Postal Service to

[14] United States Postal Service, *Phase 2 Network Rationalization Frequently Asked Questions* (Jan. 12, 2015).

reduce costs arising from mail processing facilities, but at the cost of slower service. In other words, First-Class postage did not buy the same service as it did in, say, 2006.

Reduced delivery standards impose other costs on mailers as well. For example, the reduction in service standards has also forced Presort mailers with a business-driven need to achieve overnight delivery to incur substantial costs in reconfiguring their mailing operations to achieve the significantly earlier entry times demanded by the Network Rationalization process. As a result, they now are incurring higher preparation costs to obtain a same service that they received only few years ago.

Second, separately from reducing service, the Postal Service has increased the costs faced by mailers in numerous other ways. It has done so most generally by imposing additional requirements, or by tinkering with entry regulations or mailing software, all in the name of pursuing operational efficiencies and lower costs that typically benefit only the Postal Service.[15] Frequently this form of cost shifting takes the form of "mandates" that mailers must meet simply to maintain eligibility for workshared rates. As a result, mailers must incur more costs just to obtain ostensibly the same service as they did a few years ago.

[15] NPPC is not troubled that the Postal Service pursues operational efficiencies and reduces its costs; indeed, NPPC generally applauds the Service's efforts to do so. Nonetheless, when the Service does so not through genuine efficiencies or net cost reductions, but in part or in whole through cost-shifting to mailers, it gives NPPC members great pause.

As just one example, in recent years mailers have had to incur costs to convert from POSTNET to Basic IMb, and they have been under substantial pressure to incur the additional costs of converting to Full-Service IMb. Although in Docket No. R2013-10 the Commission properly rejected the Postal Service's attempt to condition Automation rates on the use of Full-Service IMb, the Service since then has achieved much the same outcome incrementally through conditions on promotions. These barcode conversions are tantamount to substantial cost increases just to maintain eligibility for Automation rates. From the perspective of mailers, most of the benefits derived from Full-Service IMb seem to flow to the Postal Service, rather than to mailers, which may help to explain why the transition to Full-Service IMb has taken longer than the Postal Service initially expected.

For another example, mailers have incurred, and continue to incur, substantial costs in preparing for, analyzing, and attempting to correct PostalOne! upgrades that routinely suffer flaws from poor development and incomplete testing by the Postal Service. Many of these costs could have been avoided had the Postal Service properly tested the software upgrade before release. Instead, the Service has effectively shifted part of its software development costs to mailers by releasing software that it has not tested properly.

For example, only last week the Postal Service found it necessary to deploy an update numbered PostalOne! Release 40.0.1.0, just a couple of days after it issued Release 40.0 the preceding weekend. It stated that the update included "fixes for some known issues related to Release 40.0." In the interim, mailers wasted time and money trying to work through the issues to prevent the flawed software from affecting their programming and production processes. Had the Postal Service invested more effort in testing Release 40.0 before pushing it out, mailers would have suffered fewer costs and much less aggravation.

Mailers also incur still more costs in investigating and resolving issues arising from Address Correction Service software issues, which again could have been avoided had the Postal Service taken more time and effort (and expense, as necessary) to ensure that the product was truly ready.

Increasing the costs incurred by mailers simply to meet ever-shifting entry regulations and mailing software may help the Postal Service reduce its own costs, but they increase the total cost of mailing just as much as do postage rate hikes. And, as the Commission is well aware, by shifting its costs on to mailers, the Postal Service in practice is evading the constraints of a price cap.[16] Indeed, mailers routinely add these shifted costs to their postage costs (as well as their printing costs) in determining the real cost of their mailings. It is time for the Commission to consider whether the cumulative effects of these phenomena provide reason to reduce the price cap applicable to the affected products.

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[16] *See Mail Processing Network Rationalization Service Changes, 2012*, Docket No. N2012-1, at 151-153 (Sept. 28, 2012) (Advisory Opinion) (summarizing testimony of Public Representative witness Neels and NALC witness Crew).

IV. CONCLUSION

In sum, First-Class Presort mailers are currently facing a triple whammy: (1) high prices evidenced by cost coverages that persistently dwarf the system averages; (2) degraded service; and (3) higher non-postage mailing costs. It is no wonder their volumes continue to decline, no matter how encouraging other economic circumstances may be. In this proceeding, the Commission should begin to address the continuing problems facing the Postal Service's largest and most valuable mailers by reassessing whether the market-dominant rate schedule meets the just and reasonable standard, and whether the Postal Service's longstanding pricing practices for First-Class Presort Mail are consistent with the statutory objectives set by Section 3622(b) of the PAEA.

For the foregoing reasons, the National Postal Policy Council respectfully urges the Commission to take these Comments into consideration in making its Determination.

Respectfully submitted,

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