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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

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Notice of Market-Dominant	)	Docket No. R2015-4
Price Adjustment	)	
	)	

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
COMMENTS ON THE UNITED STATES POSTAL SERVICE
NOTICE OF MARKET-DOMINANT PRICE ADJUSTMENT
(February 19, 2015)

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.

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On January 15, 2015, the U.S. Postal Service ("USPS") filed its Notice of Market Dominant Price Adjustment, scheduling a rate adjustment to be implemented on April 26, 2015. On January 20, 2015, the Postal Regulatory Commission ("Commission") issued Order No. 2327, "Notice and Order on Rate Adjustments, Classification Changes, and Temporary Promotions for Market Dominant Products," seeking comments by February 4, 2015. In Order No. 2340, dated February 2, 2015, the Commission extended the deadline for comments on Standard Mail changes until 14 days after the Postal Service corrected deficiencies and thereby filed a complete Notice, by responding to certain Chairman's Information Requests.[1]

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[1] Commission Rules anticipate that a Postal Service notice of market dominant price adjustment will be complete on the date of its submission. The Commission's delay in the schedule for filing comments was predicated on an insufficient filing. In truth, the Postal Service filing continues to be insufficient, even after innumerable ChIRs. As a commenter, Valpak has had to scrutinize responses to ChIRs on a daily basis, revising its comments as necessary. The Postal Service's omissions and changes have made the job of a commenter as difficult as possible. The Postal Service case is a moving target. The Commission would have every right to require the Postal Service to notice new rates supported by a complete presentation, as required under the rules.

Those responses were filed on February 5, 2015, making the revised deadline for comments on Standard Mail changes to be February 19, 2015.

Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") hereby submit these joint Comments in response to the Postal Service's Notice.

COMMENTS

I. Postal Service Responses to Valpak-Requested Chairman's Information Requests.

As has become its established practice, the Postal Service failed to file all information required by the Commission in the present docket (or in Docket No. ACR2010), particularly with respect to Standard mail and Standard Flats.[2] On January 23, 2015, Valpak filed in the present docket a motion for issuance of an information request, asking the Commission to order the Postal Service to file certain required Standard Flats information.[3] On January 27, 2014, Chairman's Information Request No. 2[4] included question 9, which tracked Valpak's requested question 1. ChIR No. 2 question 10 tracked a question that Valpak suggested be asked in the context of the Annual Compliance Review, Docket No. ACR2014.[5] On February

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[2] *See* history of Postal Service "compliance" with Commission remedial orders regarding Standard Flats, Docket No. ACR2014, Valpak Initial Comments, Appendix (Feb. 13, 2015).

[3] http://www.prc.gov/docs/91/91215/Valpak%20Motion%20for%20ChIR%20re%202010ACD.pdf

[4] http://www.prc.gov/docs/91/91234/CHIR%20No.2.pdf

[5] In its motion, Valpak also asked the Commission to pose to the Postal Service a further question, which was never included in any ChIR: "Please explain why the information required by the Commission in its FY 2010 ACD was not provided in the Postal Service's Notice of Market-Dominant Price Adjustment (Jan. 15, 2015)."

2, 2015, the Postal Service responded to ChIR No. 2.[6] These ChIR questions and Postal Service responses thereto are set out below, together with Valpak's comments on those responses:

ChIR No. 2, Question 9:

> Pursuant to the Commission's directives in its FY 2010 Annual Compliance Determination at 107, please provide:
> a. An explanation of how the proposed prices for Standard Mail Flats will move the cost coverage for Standard Mail Flats towards 100 percent.
> b. A statement estimating the effect that the proposed prices will have in reducing the subsidy of the Standard Mail Flats product.
> c. All underlying workpapers and data used to respond to parts a and b.
>
> > Response to Question 9:
> > a. In a year when the price cap was **1.966 percent**, the Postal Service increased Standard Mail Flats prices by **2.255 percent** (15 percent above the price cap). [*note 2: The Postal Service will provide documentation for this new 2.255 percent price increase in its response to CHIR 3, Q4. Although an amended CAPCALC file will not be submitted until the Postal Service files its responses to CHIR 3, this question is being answered as though the changes have already been made. The changes will not impact any proposed prices, but result in a Standard Mail Flats price increase of **2.255**, rather than **2.466 percent**.*] The Postal Service **hopes** that the additional revenues generated by this above average price increase will improve the product's cost coverage. [Emphasis added.]

Valpak Comments: The Postal Service originally believed that it had increased Standard Flats prices by 2.466 percent. *See* Table 7, USPS Notice, p. 21. However, due to a variety of errors that were identified, that percentage increase is only 2.255 percent, as explained by the Postal Service in its response to ChIR No. 2.[7] The Postal Service

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6 http://www.prc.gov/docs/91/91327/CHIR%20No%202%20FINAL.pdf

7 That percentage continues to decline with each new submission, as it was reported to be 2.243 percent in response to ChIR No. 5 (Feb. 9, 2015).

unjustifiably boasts of its noticed **2.255 percent price increase** for Standard Flats being proposed in this docket.

- Compare that paltry **2.255 percent price increase** to the **7.3 percent cost increase**[8] in Standard Flats from FY 2013 to FY 2014. Even if Standard Flats were not deeply underwater, the Postal Service's noticed price increase covers only **36 percent** of the one-year cost increase.
- But Standard Flats continue to be deeply underwater. Consider the Postal Service's noticed **2.255 percent price increase** in light of the estimate in the ACMA Reply Comments in Docket No. ACR2014 that state (p. 2) a **22.6 percent price increase** in Standard Flats would be required to increase Standard Flats FY 2014 coverage of 81.6 percent[9] to 100 percent. The noticed 2.255 percent price increase reflects an increase of just **less than 10 percent** of the increase ACMA acknowledged is necessary to reach breakeven.

Viewed in these ways, or any other way, the noticed 2.255 percent price increase is trivial. It would do virtually nothing to achieve the Commission's objective in establishing its remedial order in Docket No. ACR2010, and subsequent ACRs.[10] In fact, the noticed price increase would represent a setback from FY 2014. Of course, the Postal Service only says that

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[8] Due to errors in the FY 2014 ACR and subsequent corrections to the underlying data, the Postal Service has made it difficult to confirm the actual costs of Standard Flats in FY 2014, and therefore difficult to calculate price changes.

[9] Apparently revised to 83.1 percent after the Postal Service's adjustment filed in USPS-FY14-45.

[10] *See* Docket No. ACR2014, Valpak Initial Comments, Appendix.

it can "**hope**" that the product's cost coverage will increase (from 81.6 percent), because cost increases during FY 2015 may yet again outstrip the Postal Service's paltry price increases for Standard Flats. Many reasons previously articulated by Valpak explain why such hopeful speculation is somewhere between baseless and reckless.[11]

The price increase in this docket must be viewed in tandem with the Commission's review of the FY 2014 ACR that is pending. The Postal Accountability and Enhancement Act ("PAEA") designed the Annual Compliance Determination to be the opportunity for the Postal Regulatory Commission to engage in a backward-looking assessment of compliance of Postal Service pricing with standards set out in Title 39. It was never meant to be based on speculative forward projections of what might happen in a Test Year, as had been the practice in Commission rate setting under the Postal Reorganization Act of 1971. Therefore, Postal Service speculation about what might or might not happen in a future fiscal year cannot override the reality of what actually happened in the Fiscal Year under review in that docket or the remedial price changes that are necessitated in this docket.

> Another way this price adjustment helps Standard Mail Flats cost coverage is the restructuring of FSS prices. This restructuring is designed to give more meaningful price incentives for mailers to prepare Flats for FSS processing, and extra incentives for mailers to prepare flats on Scheme Pallets. The Postal Service is **hopeful** that this new pricing structure will drive mailers towards behaviors that will lower flats processing costs; resulting in an improved Standard Mail Flats cost coverage. [Emphasis added.]

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[11] *See* Docket No. ACR2014, Valpak Initial Comments, pp. III-3-6; Valpak Reply Comments, pp. 13-19. Speculation about what might happen in future years is also quite irrelevant to the Commission's issuance of a meaningful remedial order to correct illegal rates in the fiscal year being examined in an annual compliance review under the current statutory scheme.

Valpak comment: Note again that the Postal Service can only "hope" that the coverage of Standard Flats will increase. In its FY 2013 ACR, the Postal Service also had similar hopes, which were relied on by the Commission, yet the coverage of Standard Flats dropped in one year from 84.9 percent to 83.1 percent. For the reasons set out above, the statutory scheme does not permit the Commission to rely on such "hopes," even if there were a basis for them.

> b. The Standard Mail Flats increase of **2.225 [sic – 2.255] percent** is well above the **minimum price increase (1.05 x CPI) approved by the Commission in FY 2013 Annual Compliance Determination**. [*note 3: Annual Compliance Determination Report: Fiscal Year 2013, PRC Docket No. ACR2013 (March 27, 2014), at 54.*] The higher flats price increase, relative to other Standard Mail products, will help lower the subsidy. The Postal Service will be revising tab "LFP Revenue@New Prices" in file "CAPCALC-STD-R2015-4" as a result of CHIR 3, question 4. This revised CAPCALC file will show proposed Standard Mail Flats revenue of $2,527,759,874, an increase of 2.255 percent. If the Postal Service had increased Standard Mail Flats by only **105% of the price cap**, as required, the proposed Standard Mail increase would have been **2.064 percent** and the proposed revenues would have been **$2,523,042,525**. The higher than required increase results in an additional **$4,717,349** in Standard Mail Flats revenue. The new FSS price structure **may** also help reduce the subsidy by reducing Flats processing costs. However, this this [sic] is more difficult to quantify, as the Postal Service **cannot predict** how mailers will react to the new incentives to prepare Flats for FSS processing. [Emphasis added.]

Valpak comment: The Postal Service brags that its tiny increase in Standard Flats rates of 2.255 percent exceeds the even tinier increase of 2.064 percent that would be the absolute minimum under the formula it proposed in the aftermath of the FY 2010 ACD ("CPI * 1.05 percent"). The Postal Service tries to blame, or at least hide behind, the Commission in asserting that this formula for a "minimum price increase (1.05 x CPI) [was] approved by the Commission in FY 2013 Annual Compliance Determination." Some context is necessary.

First, the "CPI * 1.05" formula was designed by the Postal Service, not the Commission. Second, the "CPI * 1.05" formula was expressly stated to be a "minimum" — not a baseline, and certainly not a maximum. Third, the Postal Service states that its noticed Standard Flats price increase of 2.255 percent would generate **$4.7 million** in product revenue more than a CPI * 1.05 increase — but never compares that paltry increase to the FY 2014 loss from Standard Flats of **$415 million**[12] — which needs to be eliminated. Fourth, it is highly doubtful that the Commission would have thought that the Postal Service would use this "minimum price increase" formula to defend reckless pricing, such as boasting of a 2.255 percent increase at a time that product costs increased 7.3 percent, for a product that had a coverage of only 83.1 percent. Fourth, it is impossible to believe that the Commission can be pleased that the formula that was proposed by the Postal Service in the context of the FY 2010 ACR has now resulted — four years later — in no improvement in coverage.[13]

In truth, the goals of the Commission's remedial order could never be complied with by minimal "CPI * 1.05" price increases, unless costs had dropped precipitously. As costs have increased, this formula was inadequate in FY 2014, and will be inadequate in FY 2015. The

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[12] The Postal Service originally reported that Standard Flats lost $460 million in the FY 2014 ACR, and although Valpak cannot be sure, it believes $415 million is the revised loss for Standard Flats.

[13] *See* discussion in Valpak Initial Comments, pp. III-6-7, quoted in Section II, *infra*. The Postal Service Reply Comments in Docket No. ACR2014 (pp. 22-23) try to shift the baseline from FY 2010 to FY 2011, erroneously viewing the Commission's remedial order to have been issued in its FY 2011 ACD.

way in which the Postal Service hides behind the Commission's "approval" of this formula demonstrates that it is time for the Commission to clarify its position, and impose a remedial order that cannot be evaded by a Postal Service which continues to resist the Commission's authority.[14]

> c. The Commission already has the file "CAPCALC-STD-R2015-4.xlsx" used to quantify the additional revenues that higher Standard Mail Flat prices will provide. In CHIR no. 1, the Postal Service provided 10 additional files in response to Q3b, which outlined the **FSS Flats migration** that provides expected volume movement. [Emphasis added.]

Valpak comment: The "FSS Flats migration" artificially injects profitable volume into Standard Flats to give the appearance of reduced losses. Certainly, this is no basis on which to make pricing decisions. *See* Section VI, *infra*.

ChIR No. 2, Question 10:

> 10. In its FY 2014 ACR, the Postal Service reports that the revenues for only two Standard Mail products did not cover attributable costs in FY 2014: Standard Mail Flats and Standard Mail Parcels. FY 2014 ACR at 17-19. In this docket, the Postal Service proposes approximately a 2.5 percent increase for Standard Mail Flats and approximately a 9.8 percent increase for Standard Mail Parcels. Notice at 21. Please explain why Standard Mail Parcels users can sustain a 9.8 percent increase, while Standard Mail Flats users can only sustain a 2.5 percent increase.
>
> Response to Question 10:
>
> > 10. While it is **possible** that Standard Mail Flats mailers **could sustain** a slightly higher price increase, it would be **impossible** to increase Standard Mail Flats prices by an amount similar to Standard Mail Parcels while staying within the **price cap**. This is because Flats represents a significantly larger proportion of

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[14] *See* Docket No. ACR2014, Postal Service Reply Comments, p. 11 ("[t]he Postal Service should have the flexibility to determine and employ relevant and appropriate methodologies compatible with its business model."). *See also* Docket No. ACR2014, Valpak Initial Comments, Section VI.

> Standard Mail volume and revenue than Parcels. Were the Postal Service to implement a **ten percent price increase for both Flats and Parcels**, it could not stay within the price cap without also instituting **unacceptable price decreases for letters**, which would **likely** result in **revenue losses**. Moreover, as a practical matter, since Standard Mail Parcels' current prices are significantly lower, relative to costs, than Flats' prices, *[note 4:In other words Parcels has a lower cost coverage. See Docket No. ACR2014, USPS-FY14-1 FY2014 Public Cost and Revenue Analysis Report (PCRA), file Public_FY14CRA.xlsx, tab "Cost1", cells R30 and R31.]* the Postal Service determined that a larger price increase for Parcels was necessary at this time. [Emphasis added.]

Valpak comment: The Postal Service grudgingly admits that Standard Flats mailers could sustain a higher price increase, but states only one reason why the price was not increased — because under a class-based price cap, the Postal Service would have been required to notice "unacceptable price decreases for letters." This statement is incorrect, as explained in Section V, *infra*.

Moreover, the Postal Service's response (Feb. 18, 2015) to ChIR No. 6, question 1b in Docket No. ACR2014 estimated that Standard Flats volume declined by only 1.2 percent in response to the approximately 6 percent price increases in January 2014. This demonstrates a low own-price elasticity indicating that the Postal Service should not experience significant volume loss from a Standard Flats price increase on the order of that given to Standard Parcels (9.8 percent).

However, it is worth noting that the Postal Service only ponders price mitigation for **letters** — but not for still higher coverage products, such as **HD/Saturation letters** (with a 238.0 percent coverage). And note that, yet again, the Postal Service concerns itself only with "revenue losses," continuing to be oblivious to the "net contribution" that can be earned from a product — which is the way that successful businesses must think.[15]

II. The Commission Should Coordinate Remedial Price Adjustments Required by Docket No. ACR2014 with Price Adjustments in this Docket.

Pursuant to 39 U.S.C. § 3653(b), the Commission's Annual Compliance Determination ("ACD") for FY 2014 is expected to be issued by March 27, 2015. The Postal Service's price adjustments noticed in this docket are set for implementation approximately one month later — April 26, 2015. Because of the close proximity of these two dates, price adjustments which the Commission requires in Docket No. ACR2014 should be coordinated with price adjustments which the Postal Service has noticed in Docket No. R2015-4.

Specifically, Valpak has filed comments in the ACD which urge the Commission to issue a new remedial order to correct pricing illegalities in Standard Mail, increasing the prices for Standard Flats, and holding the line or possibly even reducing prices for HD/Saturation Letters, and other products, as may be required by the price cap under 39 U.S.C. § 3622(d)(2). One of the major reasons that new remedial pricing is necessary is the deteriorating condition of

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[15] The Postal Service's late-filed Reply Comments in Docket No. ACR2014 indicate a strong preference for a pricing strategy that (i) already has lost over $3.5 billion, and (ii) knowingly and predicably will lose another $300 million (optimistically) to $500 million (pessimistically) in FY 2015. The Postal Service needs to curb its passion for losing money on underwater Standard Flats.

The Postal Service response to ChIR No. 11 filed on Feb. 18, 2015, states that it intended to increase Periodicals prices by 1.965 percent but that, by virtue of errors, the increase now will only be 1.340 percent. With the Periodicals class losing $515 million in FY 2014, this Postal Service insensitivity to losing money on favored products is as unbusinesslike as can be imagined. The Commission owes no deference to such Postal Service pricing decisions.

Standard Flats, as discussed in this except from Valpak's Initial Comments in Docket No. ACR2014:

> At the time the Commission made its finding and issued a remedial order based on FY 2010 data, the cost coverage of Standard Mail Flats was **81.6 percent**, and the product's unit loss was **8.2 cents**.[16]
>
> Now, in FY 2014, **four ACR dockets** later, after **four years** of supposed Postal Service "compliance" with the Commission's remedial order,
>
> - the cost coverage of Standard Flats is **unchanged — 81.59 [83.1]** percent, and,
> - the unit loss is **much worse** — 11 percent worse — **9.1 [8.2] cents**.[17]
>
> Total losses have shrunk from **$577** million[18] to **$460** [415] million, but only because the volume of Standard Flats decreased by approximately 2 billion pieces, from 7.068 billion to 5.054 billion. Clearly, the Commission's remedial steps cannot claim credit for the reduction in total losses resulting from lower volume. To compare apples to apples, if those 2 billion pieces were still being mailed, total losses in FY 2014 would be $642 million. [Docket No. ACR2014, Valpak Initial Comments, pp. II-6-7.]

For the preceding reason, and all of the reasons set out by Valpak in these comments and in its Initial Comments and Reply Comments in Docket No. ACR2014 (which Valpak incorporates into these comments by reference), the price adjustments for Standard Flats would perpetuate unfair and inequitable rates in violation of 39 U.S.C. § 101(d). To minimize disruption for mailers resulting from multiple rate changes, Valpak requests the Commission to coordinate pricing adjustments required by both dockets. Depending on the date on which the Commission's review in each docket is complete, it may be possible to order the remedial price

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16 *See* FY 2010 ACD, p. 103.

17 A Postal Service filing changed the numbers to the bracketed numbers on the same day those Initial Comments were due. Therefore, using the new numbers, after four ACR dockets, the cost coverage of Standard Flats has increased a scant 1.5 percentage points, while unit losses remain unchanged.

18 *See* FY 2010 ACD, p. 102.

adjustment to be made effective on the same day as these price adjustments — April 26, 2015. Alternatively, it may be necessary to postpone all price adjustments for Standard Mail to some later date, probably in May or June 2015.[19] In any event, in issuing its order in each docket, the Commission must be mindful of the desirability of only one price adjustment — if possible.

III. Postal Service Pricing Changes in Docket No. R2015-4 Will Not Solve the Problem of Illegal Standard Mail Prices as Found in Docket No. ACR2010 and Subsequent Dockets.

Table 1 provides some background for selected Standard Mail Product Price Changes noticed for April 2015, to lay the foundation to make three comparisons.

Comparing Standard Flats to HD/Saturation Letters. The average Standard Mail price increase in Docket No. R2015-4 is **1.860** percent. One deeply underwater product (parcels) has a respectable price increase of **9.794** percent. The other deeply underwater product (Standard Flats) has a barely above-CPI increase of **2.255** — an amount the Postal Service originally intended to be **2.466** percent (*compare* Postal Service Response to ChIR No. 3 *with* Table 7, Postal Service Notice). The only reason the Postal Service articulated for not giving Standard Flats a rate increase in the range that it gave Standard Parcels (9.8 percent) is bogus. *See* discussion, Section I, *supra*. For the reasons set out in Valpak's Initial and Reply Comments in Docket No. ACR2014, prices for Standard Flats should be increased as necessary

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[19] Commission Rules require the Commission to determine compliance of proposed prices within 14 days of the conclusion of the public comment period. *See* 39 C.F.R. § 3010.11(d). The Commission may need to waive that rule, or to stay this proceeding pending issuance of its FY 2014 ACD, so as to prevent the Postal Service's timing of its price adjustment causing a delay in implementation of a new remedial order until a year or more after its issuance. Certainly, in light of the moving target that the Postal Service has presented in this docket, with important elements of the case being disclosed daily, hindering the job of commenters, there is every reason to stay this proceeding.

to achieve full cost coverage in no more than two years. This increase should be offset by reductions in other high coverage products, primarily HD/Saturation Letters. *See also* Valpak Standard Mail Contribution Maximizing Model, Docket No. ACR2013, Valpak Initial Comments, Appendix.

Comparing Standard Flats to Carrier Route. It is interesting that the lowest proposed increase in Standard Mail is for the Carrier Route product, the product primarily used by catalogers. *See* ACMA Initial Comments, Docket No. ACR2014, p. 2. The Postal Service appears to have noticed prices which anticipate that the Commission will issue a further remedial order increasing Standard Flats well beyond CPI — while financially protecting favored cataloguers by giving them the lowest percentage price adjustment of any Standard Mail product for the Carrier Route product they primarily utilize. *See id*. With this low Carrier Route pricing increase on a product with below-class average cost coverage, the effect of a substantially larger price increase for Standard Flats for catalogers will be mitigated. Despite the statutory objective of transparency[20] in the rate setting process, the Postal Service never explained its reason for this low price increase for Carrier Route.

Comparing HD/Saturation Letters to HD/Saturation Flats. In the present market dominant price adjustment, the proposed increase for HD/Saturation Letters is above the Standard Mail average, while the proposed increase for HD/Saturation Flats and Parcels is nearly half a percentage point lower than average. *See* Docket No. R2015-4, Postal Service Notice (Jan. 15, 2015), p. 21. The **cumulative increase** over the last five price increases (not

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[20] *See* 39 U.S.C. § 3622(b)(6) ("To … increase the transparency of the ratemaking process.").

considering the temporary across-the-board exigent surcharge) is **8.6 percent** for HD/Saturation Letters and **7.8 percent** for HD/Saturation Flats and Parcels. With respect to highly profitable Standard Mail products, HD/Saturation Letters are noticed to be increased by 2.023 percent — above the class average — and HD/Saturation Flats and Parcels are noticed to be increased by 1.583 percent — well below the class average.

Table I
Standard Mail Products
Percentage CPI Price Increases

(ACR2014 Coverage)	R2011-2	R2012-3	R2013-1	R2013-10	R2015-4	Cumulative Increase
Lowest Coverage Products						
Standard Flats (81.6%)	0.835	2.209	2.416	1.810	2.243	9.9
Standard Parcels (66.3%)	11.346	2.864	3.081	1.820	9.794	32.0
Highest Coverage Products						
HD/Sat Letters (238.0%)	0.615	2.298	2.059	1.325	2.023	8.6
HD/Sat Flats & Parcels (227.6%)	0.403	2.121	2.092	1.393	1.583	7.8
SM Overall	1.739	2.041	2.541	1.607	1.857	10.2

Source: Docket Nos. R2011-2, R2012-3, R2013-1, and R2013-10, PRC Standard Mail Cap Calculations; USPS CAPCALC-STD-R2015-4-CHIR5.xlsx (Feb. 9, 2015).

IV. Saturation Mailers Increasingly Have Been Forced to Develop and Rely on Digital Products.

No product should be forced to pay a cost coverage of 238 percent, as does HD/Saturation Letters, while other products in the same class pay a coverage in the low 80 percent range. In Standard Mail, the highest two coverages in Standard Mail are imposed on two saturation products — which also have the highest elasticity. The Postal Service should be well aware of the fact that it is not just First-Class Mailers whose volume is threatened — the threat also includes Standard Mail. In testimony filed by Discover Financial Service ("DFS") Executive Vice President, President-U.S. Cards, and Chief Marketing Officer, Harit Talwar (Docket Nos. MC2015-13 and R2015-2), Mr. Talwar explained that one of the reasons justifying the DFS Negotiated Service Agreement was relative improvements in digital advertising vis-a-vis hard copy advertising sent through the mail.

> It is critical to understand that for us, Standard Mail is not a monopoly product for it operates in a highly competitive market that includes a wide variety of targeted digital channels. In fact, digital companies such as Google, Yahoo, and other search engine companies, as well as scores of digital marketing companies regularly come to us with presentations about how to use them more effectively and they offer packages to do so at a lower cost. Discover has many choices, and their number and effectiveness grow every year. This was not true a decade ago.[21]

Since the NSA was jointly sponsored by the Postal Service and DFS, presumably Mr. Talwar's statement also reflects the views of the Postal Service. The testimony asserts that digital advertising is constantly growing more effective, which likely could lead to a long-term secular decline in the volume of Standard Mail, especially saturation mail with the highest coverage and

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[21] http://www.prc.gov/docs/90/90560/Statement%20of%20Harit%20Talwar%20.pdf

elasticity. As more advertising dollars shift into digital (and some of those dollars likely will shift from direct mail), those in charge of postal pricing should pay close attention to the effect on highly profitable saturation mail.

V. The Postal Service Has Erroneously Claimed that It Could Not Substantially Increase Prices for both Standard Parcels and Standard Flats under the Cap.

The Postal Service claims in its response to ChIR No. 2, question 10 (set out in Section I, *supra*):

> Were the Postal Service to implement a **ten percent** price increase for both **Flats** and **Parcels**, it could not stay within the price cap without also instituting **unacceptable price decreases** for letters.... [*Id.*]

This claim appears to be in serious error.

1. As reported in the FY 2014 CRA, Standard Mail revenue was $17,496.7 million. Applying the CPI cap of 1.966 percent to these revenues, the Postal Service is proposing in this docket to set prices which will increase Standard Mail revenues by approximately $344 million. (Note that these revenue numbers include revenues from the exigent surcharge, but the analysis is similar, including or excluding exigent revenues.)

2. For Standard Parcels, the FY 2014 revenues were $68.0 million. Applying a 10 percent increase to these revenues would generate additional revenues of $6.8 million.

3. Standard Flats revenue in FY 2014 was $2,037.4 million.[22] Applying a 10 percent increase to these revenues would generate additional revenues of $203.7 million.

4. Thus, a 10 percent increase for Standard Parcels and Standard Flats would generate a total of $210.5 million in additional revenue, or $133.5 million less than the $344 million in increase permitted for the class. Therefore, contrary to the representation of the Postal Service, a 10 percent increase on Standard Parcels and Standard Flats would in no way require any price decrease for Standard Letters — or any other Standard Mail products. It would only be necessary to give other Standard Mail products a lower increase than that noticed.

If the entire remaining $133.5 million of permitted increase under the cap were applied to Standard Letters — which the Postal Service claimed to be impossible — it would enable a price increase of 1.36 percent, somewhat less than the 1.835 percent increase noticed from the Postal Service. (It is doubtful that any mailers of Standard Letters would object.) And this type of pricing would leave untouched the two most profitable and most highly elastic Standard Mail products — HD/Saturation Letters (with a coverage of 237.96 percent), and HD/Saturation Flats and Parcels (with a coverage of 227.62 percent). This type of price increase would be an important step in normalizing cost coverage and unit contribution across all Standard Mail products, while giving the highly price-sensitive HD/Saturation products an opportunity for real volume growth, and increased net contribution for the Postal Service.

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[22] ACMA has calculated that "[b]efore volume effects, reducing [the Standard Flats subsidy] to zero would require a rate increase for Standard Flats of about 22.6 percent. Docket No. ACR2014, ACMA Reply Comments, p. 2. In other words, Standard Flats revenues would need to increase by 22.6 percent just to eliminate the subsidy and cover that product's $415 million shortfall.

VI. The Postal Service's Clandestine and Unjustified Attempt to Move Over a Billion Pieces of Profitable Standard Mail into Standard Flats to Obscure Its Losses Should Be Deferred to a Separate Classification Docket.

Although never really explained, the Postal Service seems to be proposing to use this pricing docket to make major classification changes within three Standard Mail products. The Postal Service proposal would shift well over **1.5 billion pieces** out of Carrier Route and HD/Saturation Flats & Parcels into Standard Flats. Under this proposal, Carrier Route commercial volume would be **reduced by 20 percent**, and Standard Flat commercial volume would be **increased by 44 percent**. This major classification change should not be made within the rushed context of a pricing docket, especially one where the numbers keep changing, but should be transferred to a separate classification docket to consider the merits, and demerits, of this proposal.

The Postal Service gives almost no justification for this major change, stating only that: "By putting all of the FSS volumes in the same price cells, this will allow the Postal Service to send consistent pricing incentives to reward mailers that prepare and enter flats that are most advantageous to the Postal Service." Postal Service Notice, p. 22. That explanation in no way explains why all mail entered for FSS processing must be reclassified as Standard Flats. Indeed, FSS rates currently exist in Carrier Route, and HD/Saturation Letters & Parcels.

In response to a ChIR, the Postal Service asserts: "This restructuring is designed to give more meaningful price incentives for mailers to prepare Flats for FSS processing, and extra incentives for mailers to prepare flats on Scheme Pallets...." Postal Service Response to ChIR No. 2, question 9.a. However, incentives can be given without changing products, and the Postal Service admits that these price incentives may not result in any postal cost savings whatsoever, stating that any reduction of Flats costs "is more difficult to quantify, as the Postal Service cannot predict how mailers will react to the new incentives to prepare Flats for FSS processing." *Id.*, question 9.b. Again, with no evidence about the likelihood that FSS pricing will result in any cost savings, there is no logical reason to rush to re-categorize large amounts of Carrier Route and HD/Saturation Letters & Parcels volume into Standard Flats.

In addition to shoehorning a major classification change into a pricing docket, having the effect of precluding commenter and Commission scrutiny, the Postal Service has failed to comply with Commission Rule 3010.23(d)(2), which allows reasonable adjustments to the billing determinants only when the Postal Service can fully:

> **identify and explain** all adjustments. All information and calculations relied upon to develop the adjustments shall be provided together with an **explanation** of why the adjustments are appropriate. [Emphasis added.]

The Postal Service provided adjusted billing determinants, but it neither identified nor explained the adjustments, nor provided a meaningful "explanation of why the adjustments are appropriate. The Postal Service's one-sentence explanation that it will "send consistent pricing incentives to reward mailers" is inadequate because there are numerous incentives that have been implemented which do not require the shifting of billions of pieces of mail across product lines. Indeed, if this were the real reason for this substantial proposed shift of mail into Standard Flats, it would make no sense at all. It would appear, however, that another reason has motivated the Postal Service's tinkering with Standard Mail products.

The Postal Service may have hinted at this reason when it asserted that "The new FSS price structure **may also help reduce the subsidy** [to Standard Flats] **by reducing Flats processing costs**." Postal Service Response to ChIR No. 2, question 9.b (emphasis added). Of course, since the Postal Service disclaims that it "cannot predict how mailers will react to the new incentives," it cannot represent that postal costs will be reduced in the slightest, nor that the subsidy to Standard Flats will be reduced in the slightest.[23] However, it may be that the Postal Service is concerned about appearances. Doubtless, moving profitable mail from Carrier Route and HD/Saturation Flats & Parcels into unprofitable Standard Flats would give the appearance of reducing the subsidy to Standard Flats.

Indeed, should the Commission permit this classification change, then in the FY 2015 ACR, it can be expected that Standard Flats will look to be a much healthier product than today — the unit cost will drop, and the cost coverage will increase. The Postal Service could tout that FSS deployment is working and that its new pricing structure has helped improve costs. However, it can also be expected that the cost coverage of Carrier Route mail and HD/Saturation Flats and Parcels — from which these profitable pieces are being shifted — will see lower coverages, albeit still in excess of 100 percent. Both commenters and the Commission likely will be unable to evaluate the unit cost and cost coverage of current Standard Flats volume apart from the infusion of new profitable volume. Without admitting what it was doing, or why it was doing it, the Postal Service seems to be implementing a variant of the oft-proposed ACMA recommendation, that the coverage of underwater Standard Flats be melded together in some fashion with somewhat profitable Carrier Route, and highly profitable HD/Saturation Flats. *See* Docket No. ACR2014, ACMA Initial Comments, pp. 3-5.

[23] If the Commission wants to rely on such forward-looking speculation by the Postal Service — rather than the financial facts of FY 2014 — its rules should require the Postal Service to submit a formal roll-forward model which could be subject to cross examination by all parties.

Continuing Standard Flats losses will be obscured so they can be continued, in violation of 39 U.S.C. § 101(d).

For example, in FY 2014, the Standard Flats product had revenue of **$2.037 billion** (with the exigent surcharge in effect for part of the year) and costs of $2.497 billion. Injecting the FSS volumes of Carrier Route and High Density flats into Standard Flats is projected to result in **revenue growth of almost $492 million** (at noticed prices) to **$2.529 billion**. The blended products inject rate cells from a marginally profitable product (Carrier Route) and a highly profitable product (HD/Saturation Flats and Parcels) to improve the cost coverage of the new Standard Flats product without actually improving the coverage of Standard Flats as it is currently defined.

Looking at one of the products that could lose volume, Carrier Route, the manipulation operates in reverse. FY 2014 revenues of $2.364 billion (including exigent surcharge revenue for part of the year) are projected to **drop by $473 million** to $1.891 billion after applying the proposed price increase (1.415 percent) to the adjusted FY 2014 billing determinants.

Thus, allowing the Postal Service's proposal to shift substantial volume among products will give the **false impression** that FSS pricing caused improvements in coverage of Standard Flats as between FY 2014 and FY 2015. In the FY 2015 ACR, if the unit cost and cost coverage of Standard Flats improve, the Postal Service could report that the FSS is working and that its new pricing structure has helped improve costs. For this reason alone, the Postal Service's proposed move of these presumably profitable price cells to the Standard Flats product should be rejected. Such an important, and potentially misleading, change designed to obscure pricing, not make it more transparent, should never have been proposed in a price adjustment docket, and should be required to be considered in a separate classification docket.

VII. Improved Postal Service Pricing Is a Necessity.

In view of the problems which the Postal Service is facing in rebuilding its vehicle fleet and making other capital expenditures (*see* Valpak Initial Comments, Docket No. ACR2014, pp. V-6-10), the Postal Service has no more latitude to await the day that underwater products break even or become profitable. All products must be profitable. Postal Service pricing must not focus on rationalizing rates designed to subsidize for-profit catalog companies, at the expense of profitable mailers which are doing much to fund the Postal Service's institutional costs.

Indeed, building a more sustainable financial structure within the price cap necessarily will require several years of gradually tightening the pricing, not only of underwater products, but also of all products whose coverage may be positive, yet uncomfortably below the systemwide average. It cannot be done overnight, but it must begin with aggressive pricing changes for Standard Flats. It is past time for the Postal Service to rationalize its tariff structure.

There are a number of instances where the Postal Service has made major increases in prices of products that were underpriced, without suffering volume declines. Many of these examples are products that were moved from market-dominant to competitive, so we no longer have available continuous data to show that the Postal Service should be bolder with respect to underpriced products. *See* the implied low elasticity of Standard Flats in the Postal Service's response to January 2014 price changes, as discussed on page 9, *supra*.

The Postal Service has refused even to consider the Valpak Standard Mail Contribution Maximizing Model, because it would provide an outside, objective method by which to evaluate how politicized pricing has become. The Postal Service would prefer for the Commission to have no method by which Postal pricing can be evaluated. The Postal Service says the Valpak Model cannot be used without product specific elasticities, but then despite Commission directives and the passage of years, claims it has been "unable" to develop those product specific elasticities that it believes to be reliable.

Valpak previously demonstrated that its Model demonstrates that price increases should be focused on deeply underwater products. This is true whether the elasticity of the product is low or medium or high. *See* Docket No. ACR2014, Valpak Initial Comments, p. IV-15. This docket would be a wonderful opportunity for the Commission to apply the Valpak model to evaluate Postal Service pricing to provide transparency as to how much contribution is being "foregone" by the Postal Service to do pricing (and classification) favors for its favorite mailers.

The Postal Service cannot afford to continue to play favorites in pricing. For a firm in a high fixed-cost network industry, especially one with a Universal Service Obligation that is both extensive and expensive, a successful, sustainable business model designed for success must be built around highly profitable products whose volume can be maintained and even grown. Letter-shaped mail that can be processed on the Postal Service's high-speed automated sorting equipment is one group of such products, provided that the Postal Service gets its act together and prices it in a way to reverse the declining volume trends and encourage volume growth. The Postal Service should be cultivating its highly profitable and price-responsive mailers, rather than exploiting them with unfair and inequitable prices in violation of Title 39. Since the Postal Service will not adhere to these basic rules of pricing, the Commission must direct it to do so.

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.