

BEFORE THE
 POSTAL REGULATORY COMMISSION
 WASHINGTON, DC 20268-0001

Section 701 Report)	
)	Docket No. PI2016-3
)	

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
 THE VALPAK FRANCHISE ASSOCIATION, INC.
 COMMENTS ON COMMISSION REPORT
 TO THE PRESIDENT AND CONGRESS PURSUANT TO SECTION 701
 OF THE POSTAL ACCOUNTABILITY AND ENHANCEMENT ACT
 (June 14, 2016)**

These Comments are submitted by Valpak Direct Marketing Systems Inc. and The Valpak Franchise Association, Inc. (hereinafter “Valpak”) in response to Commission Order 3238, on the date specified for filing of Comments.

BACKGROUND

The Postal Service is an institution of the national government that has come to be relied upon by the American people and is vitally important to the health of the U.S. economy. It traces its formal origins to July 26, 1775, when the Second Continental Congress, meeting in Philadelphia, agreed:

That a postmaster General be appointed for the United Colonies, who shall hold his office at Philada, and shall be allowed a salary of 1000 dollars per an: for himself, and 340 dollars per an: for a secretary and Comptroller, with power to appoint such, and so many deputies as to him may seem proper and necessary.

That a line of posts be appointed under the direction of the Postmaster general, from Falmouth in New England to Savannah in Georgia, with as many cross posts as he shall think fit.¹

Over the years, the revenue stream of the Postal Service has been protected statutorily by a monopoly over the carriage of letters and the mailbox monopoly, and enhanced by certain direct subsidies.² On the other hand, its expenses have not been entirely in its own control, as Congress has required that it operate in accordance with certain constraints.

The manner in which postal rates are set has undergone fundamental shifts:

- Prior to 1971, the **United States Congress** set postal rates.
- With the enactment of the Postal Reorganization Act of 1970, the regulator, the **Postal Rate Commission** set postal rates, following the request of the Postal Service.
- With the enactment of the Postal Accountability and Enhancement Act (“PAEA”) in December 2006, the monopoly itself, the **U.S. Postal Service**, was been given a degree of “flexibility” to set rates for market dominant products — so long as those rates are in compliance with Title 39.

Of course, allowing the postal monopolist the authority to set its own rates is the most dangerous of all possible options for mailers of market dominant products. Knowing this, Congress entrusted the Postal Regulatory Commission with the responsibility of ensuring that those rates were in accordance with the limitations imposed by Title 39. And in order for Congress to ensure that the Commission does its job, it was entirely appropriate for Congress

¹ USPS Publication 100, The United States Postal Service: An American History 1775 - 2006, http://about.usps.com/publications/pub100/pub100_001.htm.

² Contrary to popular belief, however, the U.S. Constitution does not specifically require the existence of a national postal service, but authorizes Congress “To establish Post Offices and Post Roads....” U.S. Constitution, Article I, Section 8.

to require the Commission to report on how well PAEA is operating. The **Section 701 Report** to the President and to Congress requires the Commission to review not just the finances and operations of the Postal Service related to the operations of the PAEA amendment, but also to report on its own performance under PAEA, and to recommend legislative changes, if needed.

Strangely, PAEA Section 701 requires the Commission to solicit the input only of the Postal Service, and does not require the Commission to take into account input from the public. Yet neither the regulator Commission nor the regulated Postal Service can be expected to tell the entire story as to how well PAEA is operating. This oversight in Section 701 in failing to require input from the mailing public would be particularly egregious whenever there has been a regulatory failure, such as the Commission allowing the Postal Service unlawful latitude to engage in unlawful practices. Neither the Commission nor the Postal Service could be expected to report to the President and the Congress that the Commission has failed to properly constrain the Postal Service from doing something wrong.

Fortunately, the Commission in Order No. 3238 acknowledged “the value of input from public stakeholders on matters concerning the operation of the provisions of the PAEA and ideas for legislative reform,” and established a procedure by which interested parties, including mailers, may submit comments to the Commission as well. Hopefully, these comments and the comments of other mailers will help provide a more complete review of the operation of PAEA.

COMMENTS

I. RESPONSE TO U.S. POSTAL SERVICE LEGISLATIVE PROPOSALS

In light of the Commission’s recognition of “the value of input from public stakeholders on ... ideas for legislative reform” (Order No. 3238 at 4), these comments begin by addressing the legislative proposals presented earlier this year by Postmaster General Megan J. Brennan both to the Senate Homeland Security and Governmental Affairs Committee³ and the House Oversight and Government Reform Committee.⁴

A. Re-instituting Exigent Surcharge

Postmaster General Megan Brennan proposed that the 4.3 percent exigent surcharge which expired on April 10, 2016, be reinstated and made a permanent part of the rate base. In her congressional testimony, General Brennan unleashed a broadside against the PAEA’s price cap, claiming that it is preventing the Postal Service from achieving “financial stability despite the best efforts of the Postal Service to reduce costs.” She also claims that without the exigent surcharge revenue, the Postal Service will lose \$2 billion of net income per year. (Similarly, section 301 of S. 2051, Improving Postal Operations, Service, and Transparency Act of 2015, would reinstate the exigent rates and make them part of the rate base.) If Congress were to

³ See Statement of Megan J. Brennan, Postmaster General and Chief Executive Officer, United States Postal Service, before the Senate Homeland Security and Governmental Affairs Committee (Jan. 21, 2016), at <http://www.hsgac.senate.gov/hearings/laying-out-the-reality-of-the-united-states-postal-service>.

⁴ See Written Testimony, Megan J. Brennan (May 11, 2016) <https://oversight.house.gov/wp-content/uploads/2016/05/Brennan-USPS-Statement-5-11-Postal-Reform.pdf>.

grant this request, and override the pricing mechanism established in PAEA, it would have several adverse effects.

1. Having Congress mandate the return of the surcharge would be a repudiation of the pricing mechanism established in PAEA, including the role of the Commission in reviewing requests for exigent rates — even after the Commission’s exercise of that power has been reviewed and approved by a federal court of appeals. It would return mailers to the era before PAEA, and indeed, even before the Postal Reorganization Act of 1970 (“PRA”), when postal pricing was set by Congress. It would tell mailers (and, indeed, the Postal Service) that they must focus their work on lobbying Congress, because Congress no longer trusts or relies on the regulatory scheme that it established. And, if the Postal Service loses money from the Congressionally imposed pricing and the loss of volume that will likely result, Congress should be ready to appropriate from the U.S. Treasury to cover losses incurred by the Postal Service.

2. The 2014 exigent surcharge was imposed in an across-the-board manner, arguably contrary to the intent of PAEA. It was not allocated based on market demand factors, or designed to lift underwater products out of debt or provide relief to other products bearing disproportionately and unfair coverages. Congress should not compel that pricing which violates Title 39 is made part of the base rates for each product.

3. Despite the Postmaster General’s claims that the Postal Service is doing all it can to reduce costs, a Congressionally enacted price increase would destroy the incentive for the Postal Service to right-size its operations and develop ways in which the Postal Service can be made to operate in a more business-like fashion. The Postal Service is certainly not doing all it could in the areas of pricing or cost reduction to achieve financial stability, as discussed in

Section II, and granting the Postmaster General's request would relieve the pressure to cut costs further and to set prices in a businesslike manner.

B. Full Medicare Integration and Postal-Specific Demographic Assumptions for Pension Liabilities

Two of Postmaster General Brennan's other legislative proposals, however, are worthy of favorable Congressional consideration. First, Postal Service retirees' health benefits should be fully integrated into Medicare Parts A, B, and D. The Postal Service and its employees have been contributing to Medicare, but only a small percentage of eligible retirees participate in Medicare Part A. Such a change would substantially reduce the Postal Service's Retiree Health Benefit liability.

Second, the Postmaster General's proposal that OPM be required to calculate the Postal Service's FERS and CSRS liabilities using Postal Service-specific assumption, rather than government-wide assumptions, should result in the Postal Service's liabilities being more accurately calculated. The Postal Service estimates that this change alone would save the Postal Service over half a billion dollars per year.

C. Nonpostal Product Flexibility

Finally, the Postmaster General's proposed relaxation of the strict prohibition against any new nonpostal services contained in 39 U.S.C. § 404(e) appears to make sense.

Specifically, she proposed Congress allow the Postal Service to offer:

- (i) nonpostal service to state, local, and tribal governments; and
- (ii) new commercial nonpostal services which meet the following requirements:
 - (a) must be consistent with the public interest;
 - (b) must not create unfair competition with the private sector;
 - (c) must not unreasonably interfere with the value of postal services;

- (d) must be undertaken in accordance with all applicable federal laws and regulations; and
- (e) must be reasonably expected to improve the net financial position of the Postal Service.

Relaxing the prohibition on new nonpostal services as proposed to allow offerings could potentially help the Postal Service's financial position, and with the stated limitations would serve to protect its financial position from unwise, unprofitable nonpostal services.

II. GENERAL COMMENTS ON PAEA OPERATIONS

A. Postal Service Financial Situation

Dramatic improvement is needed in Postal Service finances as regards both the annual operating statement and the balance sheet. As Order No. 3238 notes, current Postal Service liquidity, although improved over the immediately preceding years, is comparatively low for an operation the size of the Postal Service. The Postal Service has total debt, both on the balance sheet as well as unfunded off-balance sheet debt, amounting to tens of billions of dollars. If the Postal Service were not a government entity, it would be considered effectively bankrupt because of the size of its debt load.⁵

Much of the Postal Service's debt is not of its own making — it reflects Congressional enactments. Nevertheless, to effect major improvements to its financial condition the Postal Service should take necessary actions that are within its control. The Postal Service needs to start somewhere, and it should start sooner rather than later to improve its liquidity substantially, to the point where it can safely undertake major commitments for needed capital

⁵ See Commission FY 2015 Financial Analysis of United States Postal Service Financial Results and 10-K Statement (Mar. 29, 2016).

investments such as new vehicles and mail processing equipment. In order to achieve a significant reduction in the cost of delivering the mail, the Postal Service had previously suggested elimination of residential Saturday delivery for all mail except parcels. Although some recipients might be indifferent to Saturday delivery, there is no question that its cessation would constitute a major across-the-board reduction in the quality of delivery service for all residential mail recipients. At the same time, the Postal Service has persisted in resisting an alternative way to achieve a major cost reduction in the cost of delivering the mail to residents — eliminating costly door delivery. Of course, this proposal too would be a reduction in the quality of delivery service for those affected. Only a favored minority that now receive expensive door delivery would have to retrieve their mail from a curbside mailbox, instead of having it brought to their door. In this year's Section 701 Report, so that intelligent cost cutting choices can be made, the Commission should suggest that Congress mandate a report from the Postal Service to identify the cost of maintaining different levels of residential service (*e.g.*, Saturday delivery, door delivery).

B. Market Dominant Rate System

These comments address two aspects of the current rate setting system for Market Dominant products: the Price Cap and Cost Coverage considered together, and then, Workshare Discounts.

1. Price Cap and Cost Coverage.

a. Commission embraces “light-handed” regulation. Not unlike other regulatory schemes, there are significant differences in how various postal stakeholders believe that PAEA was designed by Congress to operate with respect to rate setting. For example, on

September 22, 2011, the Commission issued its first Section 701 Report which gave the Commission's view — at least of that date. It set out several statements as purported fact which do not reflect a consensus view — at least not in the eyes of this mailer, such as:

For market dominant products, **the law provides** the Postal Service with **flexibility** to price these products **as it deems appropriate**, subject to a **price cap**, for each class of mail equal to the annual Consumer Price Index (CPI). [Section 701 Report: Analysis of the Postal Accountability and Enhancement Act of 2006 (Sept. 22, 2011) at 7 (emphasis added).⁶]

As mailers did not have an opportunity to comment on such statements when the report was issued in 2011, some comments are now offered. Although it might be considered unfair to conclude that this one sentence reflects a complete view of the Commission's understanding of PAEA's requirements for Market Dominant rate setting, the Commission all too frequently operates as though this was all that PAEA requires with respect to Postal Service pricing — compliance with a class-based price cap.

Market Dominant mail is that mail over which the Postal Service exercises a significant degree of market power, either because of statutory or regulatory monopoly status, or because of market factors. The primary Market Dominant classes are First-Class Mail (41.11 percent of all postal volume, and 43.49 percent of all postal revenues) and Standard Mail (51.95 percent of all postal volume) and 26.03 percent of all postal revenues). In the aggregate, Market Dominant mail consists of 97.39 percent of Postal Service volume and 73.04 percent of Postal Service revenues in FY 2015.

⁶ http://www.prc.gov/docs/75/75994/701_Report-092211.pdf.

And, it is primarily to protect mailers who use First-Class Mail and Standard Mail postal products — over which the Postal Service exercises a significant degree of market power — that the Postal Regulatory Commission exists. If the Postal Service over-prices competitive products, mail such as parcels will simply be transferred to competitors of the Postal Service, such as UPS. But with Market Dominant products, the Commission is mailers' protection from a monopoly provider, the Postal Service. For those Market Dominant products, the market cannot control Postal Service abusive pricing, and that job must fall to the Commission.

A class-based price cap provides a measure of protection from abusive pricing by the Postal Service, but **only on average for the entire class**. However, few mailers pay the average rate. For example, within Standard Mail, there are seven products,⁷ and within each of these seven products, there are many more discrete rates based on density, shape, point of entry, and other factors. Some mailers enter mail in one or only a few rate cells, making average rate changes for the entire class quite irrelevant to their bottom line. In the last Annual Compliance Review, Valpak analyzed each of these Standard Mail products and demonstrated from a comparison of cost coverage over the past four years that abusive pricing exists within Standard Mail.⁸

⁷ Letters, Flats, Parcels, Carrier Route, High-Density & Saturation Letters, High-Density & Saturation Flats and Parcels, and EDDM-R.

⁸ Cost coverage is calculated by dividing the average product revenue by the average product cost. In FY 2015, 54.4 percent of all costs were attributed, and the remainder were considered institutional.

Table I
Standard Mail Products
Cost Coverage
(FY 2012-FY 2015)

	FY 2012	FY 2013	FY 2014	FY 2015	Change FY 2012-FY 2015 (Percentage Points)
HD/Sat Letters	222.2%	235.8%	238.0%	218.5%	- 3.7
HD/Sat Flats & Parcels	217.3%	229.0%	227.6%	173.3%	- 44.0
Carrier Route	130.8%	133.4%	140.2%	131.1%	0.3
Letters	178.9%	189.0%	200.5%	203.3%	24.4
Flats	80.9%	84.9%	81.6%	80.2%	- 0.7
Parcels	85.5%	64.3%	66.3%	72.8%	- 12.7
EDDM-R	N/A	359.9%	379.1%	287.9%	N/A
Standard Mail	149.0%	159.9%	166.1%	159.8%	10.8

All Standard Mail is, basically, advertising of one sort or another. However, paraphrasing George Orwell in “Animal Farm,” “all Standard Mailers are equal, but some are more equal than others.” From the above chart it can be seen that mailers such as Valpak who enter HD/Saturation Letters consistently pay more than twice their costs — the highest coverage for any major⁹ Standard Mail product (218.5 percent). Meanwhile, catalog mailers who use Standard Flats pay only 80.2 percent of their costs — which means these favored mailers do not even pay their direct and indirect attributable costs. And, obviously, they make no coverage contribution toward institutional costs whatsoever. The shortfall caused by underwater mailers must be made up from somewhere else. The Postal Service has no market

⁹ EDDM-R is a new and very small product.

capital, and must increase prices to disfavored mailers to make up for the actual losses from choosing to lose money by handling the mail of their favored mailers. The Postal Service is rarely clear as to why it favors some mailers and disfavors other mailers, resulting in the impression that such decisions are not made for any legitimate governmental reason, but are made for political reasons — of one sort or another. And, viewing its responsibility for overseeing market dominant pricing below the class level as virtually nil, the Commission has allowed the Postal Service to allow these pricing abuses to continue for years. The Commission appears to give little attention to the Congressional charge to ensure that rates are “fair” and “equitable” — discussed *infra*. And matters are not getting better — they are getting worse. Comparing FY 2015 to FY 2012, coverage of the two underwater products within Standard Mail actually has decreased:

- Standard Parcels’ coverage has decreased by 12.7 percentage points; and
- Standard Flats’ coverage has decreased by 0.7 percentage points (despite supposedly receiving “above-CPI” increases).

The issue of “fair” and “equitable” pricing concerns far more than compliance with the class-based price cap. It also can be examined from the standpoint of changes in unit contribution for each product. Table II, *infra*, sets out changes in unit contribution over three years for all Standard Mail products.

Table II
Standard Mail Products
Unit Contribution (marginal revenue)
(FY 2012-FY 2015)
(cents)

	FY 2012	FY 2013	FY 2014	FY 2015	Change FY 2012- FY 2015	Percentage Change
HD/Sat Letters	7.5	8.1	8.5	8.3	0.8	10.7%
HD/Sat Flats & Parcels	8.9	9.6	10.0	7.7	-1.2	-13.5%
Carrier Route	5.7	6.2	7.6	6.4	0.7	12.3%
Letters	8.5	9.3	10.3	10.7	2.2	25.9%
Flats	-9.0	-6.8	-9.1	-9.9	-0.9	-10.00%
Parcels	-17.5	-54.0	-52.5	-40.2	-22.7	-129.7%
EDDM-R	N/A	10.3	12.3	11.6	N/A	N/A
Standard Mail	6.9	7.9	8.7	8.3	1.4	20.3%

Standard Flats unit losses improved significantly in FY 2013, but then reversed direction, increasing from -6.8 cents to -9.9 cents in FY 2015, more than wiping out all the “gains” made in FY 2013. **To put it another way, under Postal Service pricing, it chooses to lose a dime for every piece of Standard Flats it handles.** These increased losses occurred despite the 4.3 percent exigent (above CPI) price increase, which was eliminated on April 10, 2016. Therefore, with almost no authority to increase CPI-limited prices, one can expect that the unit contribution (and cost coverage) of Standard Flats will be even worse in FY 2017.

The other notable feature about Table II is that unit contribution from **HD/Saturation Letters** has **grown by 10.7 percent**, while unit contribution from its sister product,

HD/Saturation Flats, has **dropped by 13.5 percent**. There is no possible justification for this disparity.¹⁰

b. Near total disregard of postal pricing rules. Such profoundly variant pricing within Standard Mail raises the question as to where the problem lies — is the Commission not doing its job, or are statutory changes needed to prevent such abusive pricing? For the reasons stated above, the Commission seems to believe that Congress vested almost complete pricing flexibility in the Postal Service, and the process by which it reviews noticed prices address only the price cap, workshare discounts, and nonprofit rates. Such a view of PAEA reduces the role of the Commission in protecting the most vulnerable mailers — Market Dominant mailers — to near irrelevancy. However, there are other, critically important pricing considerations contained in Title 39 which should constrain Postal Service pricing flexibility, but these have been largely rendered irrelevant by the Commission over the years.¹¹

For example, 39 U.S.C. § 101 sets out the basic postal policy of the United States. It requires that:

Postal rates shall be established to apportion the costs of all postal operations to all users of the mail on a **fair and equitable** basis.” [39 U.S.C. § 101(d).]

Further, 39 U.S.C. § 403 sets out the “General duties” of the Postal Service. It states:

¹⁰ This disparity will worsen as the Postal Service gave HD/Saturation Letters an above-average price increase (1.979 percent), while giving HD/Saturation Flats a below-average price increase (1.796 percent) in the last price adjustment. *See* Docket No. R2015-4, Order No. 2472 at 33.

¹¹ A check on price cap compliance alone could be performed once per year by a part-time contract employee — it certainly would not require five commissioners supported by a significant legal and technical staff.

In providing services and in establishing classifications, rates, and fees under this title, the Postal Service shall not, except as specifically authorized in this title, make any **undue or unreasonable discrimination** among users of the mails, nor shall it grant any **undue or unreasonable preferences** to any such user. [39 U.S.C. § 403(d) (emphasis added).]

Additionally, 39 U.S.C. § 404 sets out the “specific powers” of the Postal Service. It provides as follows:

Except as otherwise provided, the Governors are authorized to establish reasonable and equitable classes of mail and **reasonable and equitable rates** of postage and fees for postal services in accordance with the provisions of chapter 36. Postal rates and fees shall be **reasonable and equitable** and sufficient to enable the Postal Service, under best practices of honest, efficient, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States. [39 U.S.C. § 404(b) (emphasis added).]

Lastly, the factors and objectives set out in 39 U.S.C. § 3622,¹² designed to guide the Commission’s creation of the “modern system for regulating rates” for the pricing of market dominant products — factors and objectives which were carried over into the Commission’s regulations — are generally disregarded by the Commission, even in its Annual Compliance Review where the Commission is supposed to evaluate the lawfulness of Postal Service pricing.

Moreover, the Commission has many times stated that PAEA was designed to eliminate cost-based pricing. *See, e.g.*, Docket No. R2010-4, Order No. 547 at 10. However, that conclusion may come as a surprise to Congress, as Title 39 is replete with references to the

¹² For an analysis of how these factors and objectives apply to one Standard Mail postal product — Standard Flats — *see* Valpak Reply Comments on the USPS FY 2014 Annual Compliance Report, Appendix A (Feb. 13, 2015), <http://www.prc.gov/docs/91/91483/Valpak%20Reply%20Comments.pdf>.

importance of costs in setting rates.¹³ The Postal Service essentially asserts that Congress gave it the pricing flexibility to set prices irrespective of costs, and without regard to fairness, equity, reasonableness, discrimination, and other factors, so long as it adheres to the class-based price cap. And the Commission appears to agree that the Postal Service has this power. If the Commission feels it is powerless to remedy unfair pricing of this sort, it now has the responsibility to ask Congress to give it additional remedial powers in this year's Section 701 Report.

However, the Commission has great power to issue remedial pricing. The Commission's remedial powers are plenary, including ordering product price changes, or even the termination of a product. *See* 39 U.S.C. § 3662(c). As a result, the problem appears to be not so much with PAEA as it is with a Commission that has refused to exercise its statutory powers in controlling pricing abuses by the monopolistic postal service. The Commission has allowed the Postal Service to favor certain mailers, and to disfavor others. And perversely, Postal Service pricing abuses its best and most profitable customers, while rewarding its worst and most unprofitable customers. The price tag in aggregate losses to the Postal Service of this abusive monopoly pricing is enormous and growing. *See* Section d *infra*.

c. Illegal Standard Flats pricing. Under PAEA, the Commission has the duty to conduct an Annual Compliance Review, and issue an Annual Compliance Determination. Since 2008, the Commission appears to have made but one unequivocal determination that

¹³ *See* Valpak Reply Comments on the USPS FY 2010 Annual Compliance Report (Feb. 17, 2011), Appendix A, <http://www.prc.gov/docs/72/72015/VP%20ACR2010%20Reply%20Comments.pdf>.

Postal Service rates were not in compliance with Title 39, and that was in its FY 2010 ACD with respect to Standard Flats.¹⁴ The Postal Service challenged that finding in the U.S. Court of Appeals for the D.C. Circuit, but lost that challenge. However, the Postal Service never took meaningful action to correct the violation, and the Commission acquiesced.

Now, fully five years later, it is instructive to revisit the Commission’s post-appeal order regarding Standard Flats explaining its reasons for making its finding of noncompliance in the FY 2010 ACD, and supposedly ordering remedial action. We review the reasons the Commission gave then, and all the factors identified — when the Commission found noncompliance in FY 2010 — to show they again (or still) are present in FY 2015.

As Valpak told the Commission in its Initial Comments in Docket No. ACR2015, although subsidized users of Standard Flats would prefer for the Commission to do nothing so that their gravy train can continue rolling on, the Commission cannot legally continue to do the same thing over and over and expect different results. The following considers the specific factors that the Commission found persuasive in FY 2010, and checks off how many of them apply fully in FY 2015:

- “a significant and growing cost coverage shortfall”:
 - ✓ **\$522 million** in FY 2015
- “duration of the shortfall over a significant period”:
 - ✓ annual losses in the **eight years** since FY 2008, totaling **\$3.9 billion**
- “evidence that the cost coverage shortfall was likely to increase further”:

¹⁴ FY 2010 Annual Compliance Determination (Mar. 29, 2011) at 16.

- ✓ The Postal Service has no plan for cost savings adequate to address coverage, pricing plans will not be effective, the exigent surcharge expired in April, and the Postal Service itself professes it has no timetable for eliminating the shortfall.
- “a significant adverse impact on users of other mail products (some of whom could be competitors of mailers of the subsidized mail product) requiring subsidization of the non-complying product”:
 - ✓ Other Standard Mail users — most of which are commercial mailers — pay coverages well in excess of average. However, for those mailers, some of their contribution to the Postal Service’s institutional costs is being syphoned off by Standard Mail Flats and Parcels.
- “failure of the Postal Service to address the shortfall by rate increases, cost decreases, or a combination thereof, despite the capability to do so”:
 - ✓ The Postal Service has implemented barely above-average prices for Standard Flats in the most recent price adjustments, and even those have not kept up with the increase in costs. On the costs side, the Postal Service’s efforts to decrease them have been inadequate or nonexistent, as the costs continue to rise. Thus, despite the Postal Service’s capabilities, its combination of rate increases and cost decreases have failed to reverse the shortfall.
- “failure of the Postal Service to provide an adequate explanation for not taking necessary remedial steps designed to ameliorate the cost coverage shortfall”:

✓ The Postal Service's only explanation in its ACR is that "it is very difficult to predict when the shortfall for Standard Mail Flats will be phased out," but it will not be eliminated by the end of FY 2016. *See* FY 2015 ACR at 30.

Valpak argued in Docket No. ACR2015 that if these six factors taken together were sufficient to mandate triggering § 101(d)'s failsafe provisions in FY 2010, then the same must be true in FY 2015. The Commission considered FY 2010 Standard Flats an "extreme case," and Valpak urged it do so again, pointing out that the Administrative Procedure Act would require that it set out a principled rationale for a reversal of position. *See, e.g., Mfrs. Rw'y Co. v. Surface Transportation Board*, 676 F.3d 1094, 1096 (D.C. Cir. 2012).

However, in Docket No. ACR2015, the Commission made no further finding of violation, and entered no further remedial order. It did, however, require the Postal Service to file yet another report, 120 days after the ACD was issued, or July 26, 2016.¹⁵ Again, Valpak and other aggrieved mailers must continue to wait to see if the Commission will continue to protect Postal Service favored mailers or whether it will do its duty under PAEA to compel lawful, compensatory prices.

d. Aggregate losses from underwater products. It is truly astounding that since PAEA was enacted, that the Postal Service has chosen to lose over \$10 billion on underwater products, and even more astounding that the regulator Commission has allowed it to do so. Congress never authorized that \$10 billion be wasted in this way, and it would be a mistake to blame the law enacted by Congress for what the Postal Service and Commission

¹⁵ *See* FY 2015 ACD at 64-65.

have done. However, if the Commission believes that it does not have the tools to staunch this hemorrhaging, it must ask Congress to give it those tools. If it believes that these losses are mandated by PAEA, the Commission must ask Congress to change those provisions of law.

Table III demonstrates the devastating losses that the Postal Service and Commission have allowed to be incurred.

Table III
Losses on Market Dominant Products Under PAEA
(Exclusive of Special Services)
FY 2008-2015
(millions)

Product	2008	2009	2010	2011	2012	2013	2014	2015	Total
First-Class Parcels	—	—	—	—	\$10	\$3	—	—	\$13
Inbound Int. Single-Piece First-Class Mail	\$102	\$105	\$53	\$33	\$93	—	\$54	\$75	\$515
Standard Mail Flats	\$218	\$616	\$577	\$643	\$528	\$376	\$411	\$520	\$3,889
Standard Mail Parcels	\$165	\$205	\$172	\$112	\$49	\$35	\$31	\$24	\$793
Periodicals Within County	\$4	\$13	\$24	\$19	\$28	\$21	\$18	\$22	\$149
Periodicals Outside County	\$434	\$629	\$587	\$590	\$642	\$500	\$490	\$490	\$4,362
Single-Piece Parcel Post	\$64	\$61	\$134	\$88	\$66	\$23	N/A	N/A	\$436
Bound Printed Matter Parcels	—	\$7	\$27	\$4	—	—	—	—	\$38
Media and Library Mail	\$58	\$74	\$89	\$98	\$56	\$56	\$20	\$84	\$535
Total	\$1,045	\$1,710	\$1,663	\$1,587	\$1,472	\$1,014	\$1,024	\$1,215	\$10,730

Sources: FY 2008-2015 ACDs.

e. **Absence of USPS pricing model.** Lastly, one might think that such abusive pricing could be excused if it were based on the outcome of some sophisticated pricing system which operates to comply with the law, but this is not the case.¹⁶ The Postal Service appears

¹⁶ Valpak offered a Standard Mail Contribution Maximizing Model in several pricing dockets as well as in Docket Nos. ACR2012, ACR2013, ACR2014, and ACR2015, yet it was

not to possess any formal pricing model for market dominant products, most especially a model that incorporates consideration of elasticity of demand and marginal revenue. A recent report by the Office of the Inspector General (“OIG”) — “Market Dominant Price Adjustment Filings,” Report Number [CP-AR-16-003](#) (Jan. 13, 2016) — states that the pricing group does not have any model which they update and use on a consistent basis. According to the OIG:

The Pricing department did not have documented and repeatable processes to guide the preparation of price adjustment proposals filed with the PRC. The Pricing department developed prices based on **institutional knowledge** and data and economic analyses. Based on their **experience** and analyses, they understand which products are at risk of a significant decrease in volume when prices increase. [*Id.* at 6 (emphasis added).]

The Postal Service’s setting of prices on the basis of what the OIG refers to as “institutional knowledge” and “experience” would appear to be little more than a euphemism for pricing that is arbitrary, capricious, and designed to facilitate rewarding favored mailers. Implicit in this description is that the Pricing department regularly gives short shrift to the Postal Service’s estimated elasticities of demand for all of its various products. One alleged intent of PAEA was to increase accountability, but with respect to underwater products, there has been no accountability for pricing decisions, that — like a hidden stamp tax — have imposed over \$10 billion on mailers of compensatory products.

Based on observed adjustments submitted in pricing dockets under PAEA, the OIG’s description of Postal Service pricing would appear to be reasonably accurate. The Postal

largely dismissed by the Postal Service and disregarded by the Commission. *See* Docket No. ACR2012, Valpak Initial Comments at 80-107; Docket No. ACR2013, Valpak Initial Comments at 40-42; Docket No. ACR2014, Valpak Initial Comments at IV-8-IV-17; and Docket No. ACR2015, Valpak Initial Comments at 37.

Service has never proffered a model designed to show the maximum contribution that might be available from its recurring price adjustments.¹⁷ Under the circumstances, it should come as no surprise that Postal Service prices provide mailers the wrong signals and are economically inefficient. The Postal Service's own contribution and finances suffer as a result. For the reasons set out above, the Postal Service and the Commission must, together, share responsibility.

f. Cross-subsidization of individual market dominant products. There is one area of PAEA which could be improved by Congress. PAEA explicitly recognizes the possibility that the Postal Service might deliberately price competitive products below cost and cross-subsidize them with revenue from market dominant products. The statutory requirement that every competitive product cover its cost aligns with the prohibition against cross-subsidization of competitive products. That is, if revenue from each competitive product covers its incremental cost (*see* section 2, *infra*), then by definition no subsidy is required. Unfortunately, however, no such specific prohibition with respect to cross-subsidization within market dominant products has been enforced by the Commission.

The Postal Service continues to create a highly un-level playing field among competing mailers by awarding subsidies, at the expense of some mailers, to those market dominant products which it chooses to favor. As noted above, in the prior Section 701 Report the

¹⁷ The Postal Service claims to have a "model" developed by Christensen Associates which shows that if contribution is not a consideration, and the negative effect of underwater Standard Flats on net contribution is ignored, gross revenue may be sustained at a higher level than would exist if increasing net contribution were given priority. Increases in losses from Standard Flats demonstrates the inadequacies and predictive failure of that model. Docket No. ACR2012, Scenario Analysis for Standard Mail Contribution, in USPS-LR-FY12-43.

Commission correctly referred to such within class cross-subsidies as an “inequity,” one which the Postal Service could cure readily with its pricing flexibility. At present, there is no transparency into the Postal Service’s reasons for the subsidies which it continues to dole out each year. Valpak respectfully recommends that the Commission ask Congress to amend PAEA to prohibit these cross-subsidies, and if there is to be a transitional period while pricing is being made rational, require a detailed explanation why each underwater product deserves to have some of the costs which it causes to be subsidized by other mailers.

The Commission’s 2011 Section 701 Report stated that PAEA has provided increased transparency.¹⁸ That increased transparency has shown clearly the extent to which underwater products are being cross-subsidized by other products. However, beyond identifying those products and establishing the amount of the cross-subsidy for all to see, as noted above that limited transparency has not provided overburdened mailers with any fiscal relief or light on the Postal Service’s rationale for their continued existence.

The 2011 Section 701 Report discusses the Commission’s then-recent finding that the Postal Service is out of compliance with respect to Standard Mail Flats in FY2010. An accompanying footnote also states that “Section 3653(c) of title 39 states that the Commission **shall** take **appropriate** action in accordance with subsections (c) and (e) of section 3662 if the Commission makes a determination of noncompliance.” P. 11 (emphasis added). This year’s Section 701 Report should note that the Postal Service has taken advantage of the Commission’s “light-handed” approach to regulation and, in consequence thereof, has failed to

¹⁸ See FY 2011 Section 701 Report at 7, 25.

be in compliance with law each and every fiscal year since then. The result clearly indicates that the Commission's limited "light-handed" actions have been neither appropriate nor sufficient to rectify the noncompliance.

g. Recommendations. A first step which the Postal Service already should have taken on its own initiative is to stop the annual hemorrhaging from underwater products.

In its 2011 Section 701 Report, the Commission addressed this subject as follows:

While the Postal Service has used its pricing flexibility to address products that do not cover costs in some instances, it has not done so in other cases. The Commission finds that the Postal Service could utilize this flexibility more broadly. For instance, in its most recent ACD, the Commission found that the Postal Service had not made sufficient use of its pricing flexibility to address the subsidy of **unprofitable Standard Mail flats** by users of other Standard Mail products despite repeated encouragement. FY 2010 ACD, March 29, 2011, at 102-03, 106. The Commission highlighted the fact that since 2008, the Postal Service continually failed to use its within-class pricing flexibility to correct **this inequity** by giving Standard Mail Flats mailpieces below-average price increases while giving other profitable products higher than average price increases. [2011 Section 701 Report at 35 (emphasis added).]

Regrettably, the above language in that prior Report could largely be repeated in this year's Report because in the last five years there has been no material improvement in the pricing of Standard Flats.

Order No. 3238 also noted that "the 2011 [Section 701] Report recommended that if Congress chose to allow the Postal Service to introduce new non-postal services, it should include adequate safeguards to **reduce the potential for the introduction of unprofitable products.**" *Id.* at 3 (emphasis added). Here the Commission explicitly recognized that any operating losses on **new unprofitable (underwater) products** will detract from the Postal

Service's financial condition. The same logic and the same concern for the Postal Service's financial condition also should be extended to **existing unprofitable products** in this year's Section 701 Report. That is, there needs to be a more adequate statutory safeguard for reducing the loss from unprofitable products because existing safeguards have not been able to effect any material reduction in those losses. Accordingly, Valpak urges the Commission to recommend to Congress an amendment to PAEA that would require that every market dominant **product** in each profitable class of mail cover its **incremental cost** (as estimated by the Commission's accepted methodology) plus make a meaningful contribution to institutional costs.

PAEA now contains somewhat vague language that has never been followed by the Postal Service or the Commission about each product making an "appropriate" contribution in addition to the product's cost. Each product should be required to pay not just its attributable cost, but its incremental cost. Further, considering that a system-wide coverage of between 160 and 180 percent of attributable cost is required for the Postal Service to break even, every product should be required to make at least a "meaningful" contribution.¹⁹

2. Require use of incremental costs.

In the UPS Docket, No. RM2016-2, no party demurred to the proposition that for a multi-product firm such as the Postal Service the appropriate measure of the **total cost** caused

¹⁹ Despite the importance of incremental cost discussed extensively in Docket No. RM2016-2, the Postal Service has never submitted estimates of incremental cost for every individual market dominant product. Nor has the Commission required the Postal Service to submit estimates of incremental cost. Hence the systemwide coverage of incremental cost regrettably is not known.

by a product is **incremental** cost. Every party and every witness who testified on the topic of cost causality agreed that **incremental cost** is now the accepted standard in regulatory economics for the **total cost** which a product causes. However, the predecessor to PAEA, the PRA, which was drafted in the late 1960s and took effect in 1970, has been interpreted as referring only to attributable cost. Accordingly, Valpak urges the Commission to recommend to Congress that where PAEA refers, either explicitly or implicitly, to the total costs that a product causes the Postal Service to incur, the statute be amended to refer to **incremental cost** where appropriate.²⁰

3. **Workshare discounts.**

Commission Order No. 3238 (Apr. 14, 2016) commencing this docket states that:

Under the PAEA, the Commission must review workshare discounts to ensure that the discounts do not exceed the Postal Service's avoided costs, subject to limited exceptions. Legally, workshare discounts are only bound by this ceiling; the Postal Service is not bound by this provision to increase a workshare discount that is less than avoided costs. [*Id.* at 6.]

The Commission accurately sets out the provisions of current law, which permits the Postal Service to set workshare discounts well below avoided costs. In this respect, current law is flawed, as the law also requires workshare pricing designed to achieve the most efficient outcome — “lowest combined cost.” “Lowest combined cost” is widely considered to be the most efficient, socially optimal level for workshare discounts, and is the “gold standard” for workshare discounts. Such “lowest combined cost” can only be achieved by setting workshare

²⁰ When the statute refers to costs for pricing decisions, it would be appropriate to retain references to **attributable** cost.

discounts **equal to** costs avoided, and this is what PAEA should have required — and what Congress should now amend PAEA to require.

Under current law, the price cap actually gives the Postal Service a perverse incentive to reduce workshare discounts below costs avoided, moving us far away from “lowest combined cost.” The incentive to do so may be especially strong when the Postal Service is faced with low liquidity on its balance sheet. It is certainly true that some workshare discounts are set above costs avoided, which requires the Postal Service to provide an explanation and justification to the Commission. However, there have been notable occasions where the Postal Service has used its pricing flexibility to set some workshare discounts below costs avoided, and almost invariably those less-than-optimal discounts have been received with understandable contention by affected mailers.

The Postal Service is fond of pointing to the fact that PAEA gives the Postal Service increased pricing flexibility over the system that existed under the Postal Reorganization Act of 1970, when the Commission set postal rates. At the same time, in the area of workshare discounts, as Order No. 3238 notes, PAEA limits that flexibility by establishing costs avoided as an upper bound on workshare discounts. Rather than an upper bound, workshare discounts should be set **equal to** costs avoided, as nearly as possible, and the Commission should have the authority to increase workshare discounts to that level if set by the Postal Service below 100 percent of costs avoided.

4. Mail preparation rule changes which are price changes.

In 2013, the Postal Service issued a notice that Full-Service IMb would be required for mailers to continue to be eligible for automation prices. However, in Docket No. R2013-10,

the Commission determined that such a requirement is a classification change that would result in a redefinition of rate cells, thus requiring a price cap calculation. *See* Order No. 1890 (Nov. 21, 2013) at 29.

The Postal Service withdrew its proposal and appealed the Commission determination to the U.S. Court of Appeals for the D.C. Circuit. The Court of Appeals upheld the Commission's determination, but remanded for the Commission to better explain when rule changes will be treated as price changes for price cap purposes. *See United States Postal Service v. Postal Regulatory Commission*, 785 F.3d 740 (D.C. Cir. 2015).

The Commission issued its order on remand, Order No. 3047 (Jan. 22, 2016), and again, the Postal Service appealed (simultaneously filing a motion for reconsideration with the Commission).

The Commission is required to maintain the application and interpretation of the price cap for Market Dominant products,²¹ yet the Postal Service continues to seek to circumvent the price cap and challenge the Commission's interpretations. These actions by the Postal Service inject uncertainty and instability into PAEA's price setting system.

The Commission's Section 701 Report should recommend that Congress provide some clarity and stability to this aspect of the price cap by specifying that the Postal Service cannot circumvent the price cap through mail preparation rule changes which force some mailers into higher priced categories or otherwise shift substantial costs to mailers.

²¹ *See* 39 U.S.C. § 3622(a) and (d).

C. Market Dominant Negotiated Service Agreements

In the 2011 Section 701 Report, the Commission noted only one Market Dominant negotiated service agreement (“NSA”) at that time that had been proposed following enactment of PAEA, Docket No. R2011-3, Discover Financial Services NSA. 2011 Section 701 Report at 55. The report went on to conclude: “Experience with the review process of market dominant and competitive NSAs, thus far, has been positive.” *Id.* at 56. It is not possible to say the same in the 2016 report.

Indeed, in the end, the Discover NSA lost the Postal Service an astonishing \$25 million over its three-year term — eclipsing the losses from the Bank of America NSA debacle. Each year, the Commission’s Annual Compliance Determination politely suggested to the Postal Service that it consider discontinuing the money losing NSA, even though the agreement was in clear violation of 39 U.S.C. § 3622(c)(10). Having waited until it was too late, and the NSA ended, the Commission determined no remedy was then available.

The Valassis NSA did not result in losses to Postal Service, because the Postal Service reported that Valassis did not enter sufficient volumes of qualifying mail to reach the discount threshold. Valassis eventually paid a \$100,000 penalty, which had been agreed to as one of the terms of the NSA.

The Postal Service has a few moderate successes with some NSAs. On balance, however, Market Dominant NSAs have been highly unprofitable.

Table IV
Summary of Market Dominant NSAs
Net Effect on Postal Service Contribution
(\$ Thousands)

	2009	2010	2011	2012	2013	2014	2015	Total
Bookspan								20
Lifeline	25	104	0					129
Bradford Group	93	(72)	(37)					(16)
Bank of America	(23,514)							(23,514)
Discover				(4,338)	(6,861)	(14,179)		(25,378)
Valassis								
PHI Acquisitions							112	112
Total	(23,396)	32	(37)	(4,338)	(6,861)	(14,179)	112	(48,647)

D. Service Quality Pricing Authority Is Not Ready for Prime Time.

Order No. 3238 commencing this docket notes in its first Section 701 Report that:

The Commission did **not recommend** any changes to existing procedures for price adjustments and indicated that it had not vetted this concept, stating that Congress should consider allowing the Postal Service increased pricing flexibility based on improvements to quality of service. *Id.* at 40. The Commission stated that **service quality pricing authority** would create “an incentive for the Postal Service to increase the service performance of its products.”²² [*Id.* at 3 (emphasis added).]

Should the Commission intend to recommend any quality of service pricing suggestions to Congress, they should cut both ways, in symmetrical fashion. That is, should the

²² The 2011 Section 701 Report stated: “The Commission **recommends** that Congress consider providing an opportunity for the Postal Service to achieve increased pricing authority for increases in quality of service.” *Id.* at 28 (emphasis added).

Commission recommend that the Postal Service be offered a financial incentive or “reward” for improving the quality of service, it also should suffer a financial penalty for deterioration in the quality of service, *e.g.*, in the form of a reduction in the price cap applicable to each class of mail for which the quality of service declines, be it a further reduction in the existing standard or a decline in actual performance as measured against the existing standard. Such a penalty provision should give the Postal Service a strong incentive to see that service both standards and actual performance are maintained at least at existing levels and are not degraded any further.

It must be remembered that service quality has two distinct, equally important aspects: (1) service *standards*, and (2) *actual* performance vis-a-vis those standards. The price cap gives the Postal Service a strong incentive to reduce costs by reducing both service standards and the actual quality of service. Already under PAEA, in conjunction with the Postal Service’s network realignment, the purpose of which is to reduce costs, it has materially reduced delivery **standards** for First-Class and Periodical Mail, yet it has suffered no penalty of any kind. Furthermore, **actual** delivery service performance probably is no better against those now-reduced standards than it was against the previous higher standards. Unfortunately, though, the quality of existing performance data are not adequate to support a definitive statement in this regard.

With the Postal Service’s operating profitability and financial liquidity at the current low level (*see* Section II.A, *supra*), implementation of any meaningful penalty provision for service degradation likely would be impractical as it might threaten the Postal Service’s

continued financial viability. Therefore, any consideration of **service quality pricing authority** should be deferred for now.

The quality of service performance data represent a fundamental issue which the Commission needs to vet fully. Since the Postal Service is responsible for producing most of the performance data, and **service quality pricing authority** would require strong independent quality controls first be established for all performance data. As a near-term goal, the Commission first should seek to have data quality improve to the point where it can assure Congress with complete confidence that incentive pricing, including both financial rewards and penalties, is a feasible option. Moreover, any pricing based on quality of service should be heavily weighted to reflect performance of the entire network. Before any such pricing is implemented, it is important that for each class of mail the Commission be able to assess with confidence whether actual reliability of service has improved or deteriorated for all service legs over which the Postal Service has control.

Respectfully submitted,

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