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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

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| Notice of Market-Dominant | ) | Docket No. R2017-1 |
| Price Adjustment | ) | |
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**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
THE VALPAK FRANCHISE ASSOCIATION, INC.
COMMENTS ON THE UNITED STATES POSTAL SERVICE
NOTICE OF MARKET-DOMINANT PRICE ADJUSTMENT**
(November 1, 2016)

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**VALPAK DIRECT MARKETING SYSTEMS, INC. AND THE VALPAK FRANCHISE ASSOCIATION, INC. COMMENTS ON THE UNITED STATES POSTAL SERVICE NOTICE OF MARKET-DOMINANT PRICE ADJUSTMENT**
(November 1, 2016)

On October 12, 2016, the U.S. Postal Service filed its Notice of Market Dominant Price Adjustment, scheduling a rate adjustment to be implemented on January 22, 2017. On October 13, 2016, the Postal Regulatory Commission issued Order No. 3565, "Notice and Order on Rate Adjustments and Classification Changes," seeking comments by November 1, 2016.

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

## I. The Postal Service's Noticed Pricing for Standard Mail Violates the Requirements of Title 39.

### A. Scope of Commission Review.

The scope of the Commission's review of Postal Service's Notice of Rate Adjustment for Market Dominant products is focused on compliance with (i) the price cap and (ii) statutory requirements concerning workshare and nonprofit discounts, and is not as wide ranging as the Commission's review of Postal Service pricing conducted during an Annual Compliance

Review when all issues are on the table. Nonetheless, Commission rules specifically require the Postal Service to include in its Notice, *inter alia*:

> (7) A discussion that demonstrates how the planned rate adjustments are designed to help achieve the **objectives** listed in **39 U.S.C. 3622(b)** and properly take into account the **factors** listed in **39 U.S.C. 3622(c)**.[1] [39 C.F.R. § 3010.12(b) (emphasis added).]

Commission rules provide that, in addition to the price cap, other issues are on the table for mailer comment as well:

> Public comments may also address **other relevant statutory provisions** and applicable **Commission orders and directives**. [39 C.F.R. § 3010.11(c) (emphasis added).]

Moreover, the rules require the Commission to evaluate the noticed prices against the requirements of Title 39:

> If planned rate adjustments are found **inconsistent with applicable law** by the Commission, the Postal Service will submit an amended notice of rate adjustment that describes the modifications to its planned rate adjustments that will bring its rate adjustments into compliance. An amended notice of rate adjustment shall be accompanied by sufficient explanatory information to show that all deficiencies identified by the Commission have been corrected. [39 C.F.R. § 3010.11(f) (emphasis added).]

For the reasons set forth in these comments, it is urged that the Commission find the planned Standard Mail price adjustments to be "inconsistent with applicable law," arbitrary and capricious, and in violation of the Commission's remedial directive issued in the FY 2010 ACD. Accordingly, the Commission must reject these noticed prices, and return the matter to the Postal Service to be corrected and resubmitted.

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[1] Valpak incorporates by reference its analysis of the factors and objectives of the Act as applied to Standard Mail pricing set out in the Appendix to its Reply Comments in Docket No. ACR2014 (Feb. 13, 2015).

These comments address the following issues:

- First, these comments address the noticed Standard Mail prices generally, including the proposal to waive all pound revenues currently being earned from flats (whether entered as Periodicals, Standard Mail, or Bound Printed Matter) under 4.0 ounces by increasing the breakpoint for flats to 4.0 ounces, and pushing the burden of making up for those lost revenues by increasing the price of letter products.

- Next, these comments focus on the Postal Service's failure to comply with the Commission's directive to substantially increase the cost coverage of Standard Mail Flats issued in the FY 2010 ACD.

- Finally, these comments address Standard Mail Workshare Discounts.

**B. The New Mandate on Pricing Imposed By Commission Order No. 3506.**

These Comments are filed in the aftermath of the Commission's most significant reform in postal costing in decades, announced in Order No. 3506 (September 9, 2016) in Docket No. RM2016-2 (Periodic Reporting).

In redefining "attributable costs" to mean "incremental costs" rather than "marginal costs," the Commission re-dedicated itself to compensatory pricing — a principle relied on by the Commission since Docket No. ACR2010 — that every Postal Service product would cover its full attributable cost — now defined as incremental cost — plus contribute to institutional costs. The Commission's Order explained:

> While each product's attributable cost will be equal to its incremental cost, marginal costs should remain the Postal Service's basis for setting prices, with the application of appropriate markups **to ensure that each product covers its incremental costs and provides an appropriate share of institutional costs.** Effectively, **the average price of a product should meet or exceed the product's average incremental cost** (the incremental cost divided by the number of pieces). **This would result in products having a cost coverage of 100 percent or greater.** [Order No. 3506 at 61 (emphasis added).]

**C. Initial Observations About Noticed Standard Mail Product Price Changes.**

Unfortunately, the Postal Service has a fundamental disagreement with the Commission, as its actions demonstrate that it does not believe that each product should cover its cost. Nor does the Postal Service believe that each product should pay "an appropriate share" of institutional costs. It does not believe that each Standard Mail product should pay prices reflecting cost coverages that are anywhere in the same ballpark.

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**Table I**
**Standard Mail Products — Price Changes and Coverages**

| | Price Changes | Coverages |
|---|---|---|
| Letters | 2.037 | 204.0 |
| Flats | 2.493 | 80.3 |
| Parcels | 1.583 | 73.4 |
| | | |
| HD/Saturation Letters | 2.211 | 219.2 |
| HD/Saturation Flats and Parcels | -2.022 | 173.5 |
| Carrier Route | -3.032 | 131.1 |
| | | |
| Overall | 0.899 | 159.8 |

Sources: Price Changes from R2017 Notice, Table 8 (as amended);
Coverages from FY 2015 ACD, PRC LR-1.
Note: Every Door Direct Mail – Retail is omitted from this chart.

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From Table I we can draw the following initial observations:

1. The Postal Service made no meaningful effort to increase the coverages of the two products which are deeply underwater: Flats (80.3 percent) and Parcels (73.4 percent).

2. The Postal Service in no way attempted to mitigate prices for the two highest coverage products, which pay more than twice their costs: Letters (204 percent) and HD/Saturation Letters (219.2 percent).

3. The Postal Service is giving an extraordinary and unjustified price break to the two medium coverage products, which will result in those products paying even lower coverages in the future: HD/Saturation Flats and Parcels (173.5 percent) and Carrier Route (131.1 percent).

4. The Postal Service is in violation of the Commission's pricing directive in FY 2010 ACD, as discussed in section II, *infra*.

5. Generally, the Postal Service is perfectly comfortable with different Standard Mail products — all of which are basically advertising mail[2] — paying prices which reflect dramatically different cost coverages, varying by almost a factor of three (73.4 percent for Parcels versus 219.2 percent for HD/Saturation Letters).

- The coverage for Parcels is **86.4 percentage points lower** than average (159.8 percent).
- The coverage for HD/Saturation Letters is **59.4 percentage points higher** than average (159.8 percent).

As arbitrary and capricious as are the Postal Service's noticed prices at first glance, upon closer examination they become even less defensible.

### D. Postal Service Proposal to Increase the Weight Break for Flats Is Unjustified, But Is Being Employed as Cover for an Arbitrary and Capricious set of Standard Mail Price Changes.

The Postal Service proposes to increase the maximum weight from 3.3 to 4.0 ounces of all flats within Standard Mail (including, but not limited to, the product Standard Mail Flats) that currently pay piece rates only. This increase in breakpoint also will benefit categories of

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[2] That Standard Mail is mostly advertising is reflected by the Postal Service changing the name of the class to "USPS Marketing Mail." *See* Postal Service Notice at 26 ("While the content may differ, each of these [Standard Mail] uses 'markets' a product, service, or the benefit of an event or an organization.").

Standard Mail letter shaped pieces that pay Standard Mail flats prices — nonautomation and nonmachinable letters. This increase in the breakpoint of 0.7 ounces, is an increase of 21 percent.

This breakpoint change for all flats in Standard Mail and some Standard mail nonautomatable/nonmachinable letters will result in substantial loss of postal revenues. Currently, every flat in Standard Mail, and nonautomatable/nonmachinable letter weighing between 3.3 and 4.0 ounces pays both a piece rate, and a pound rate. All of these pound-related revenues will be forgone, if the Postal Service proposal is adopted. The Postal Service does not set out the updated revenue implications of its proposal so they can be evaluated by the Commission, but it can be assumed that they are substantial. Explanation of the effect of the breakpoint change does not meet even the most minimal level of transparency.

Moreover, this price signal will encourage mailers to increase the weight of these pieces by up to 21 percent. Since it can be expected that mailers will respond to this price signal by increasing the weight of their mailings, this will result in an increase in the average weight of these types of mail. This will mean that the Postal Service's proposal will have an effect on not just revenue, but also costs: the Postal Service will lose weight-related revenue, and will incur additional weight-related costs.

The Postal Service has advanced no persuasive reason for this proposal — particularly at a time that it has represented to the U.S. Court of Appeals during oral argument that its finances are in such crisis that it badly needs the expired exigent pricing increase to be reinstated.[3]

The Postal Service offers only the following to justify the increase:

> The purpose of this change is to **add value** to the mail by allowing senders of automation, nonautomation, and Carrier Route flats to improve the quality of their mailpieces (*e.g.*, by adding more material to the mailpiece or by increasing the weight of the paper used) without incurring additional pound charges. In addition, this change will **simplify the rate structure** for mailers who are already mailing items weighing more than 3.3 ounces. Thus, this change continues the Service's long term strategy of simplifying the Standard Mail rate structure and adding value to the mailstream (Objective 8, and Factors 1, 6, and 7). [Postal Service Notice, pp. 27-28.]

These purposes would seem to give the appearance of a statute-based reason for this proposal, but they are just cover for an arbitrary decision. In truth, they are not reasons at all. First, it is clear that the breakpoint change would "add value" to the mail — but the increase in breakpoint weight is basically a price reduction — and reducing the price of any Standard Mail product would increase its value. If the Postal Service has money to spread around, Valpak would suggest that it "add value" to HD/Saturation Letters, at least by reducing its price increase, or even by reducing its price, since it currently pays by far the highest coverage of any Standard Mail product (219.2 percent). The rationalization offered that this change "simplifies the rate structure" is no more persuasive than "adding value." Standard Mail is entered by sophisticated mailers, and pricing is calculated by computers, not using pencils and paper.

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[3] *See* Audio of Oral Argument, U.S. Court of Appeals, D.C. Circuit, U.S. Postal Service v. Postal Rate Commission, No. 15-1297, Sept. 20, 2016.

The Postal Service explains its justification for decreasing the prices of HD/Saturation Flats and Parcels, as follows:

> approximately **480 million Flats pieces** weighing between 3.3 and 4.0 ounces that were paying higher pound-rated prices will now be paying lower piece related prices. This volume shift placed significant **downward pressure** on these price categories, **resulting in an overall price decrease**. **Had the Postal Service increased piece prices** enough to cause an overall price increase for High Density/Saturation Flats and Parcels, this would have **defeated the purpose** of increasing the maximum weight of piece-rated flats, which is to simplify the rate structure and **grow mail volume**. [Notice at 27-28 (emphasis added).]

Although not a model of clarity, the Postal Service's reference to "Flats pieces" in the section on "High Density/Saturation Flats and Parcels" appears to be saying that there are 480 million pieces of HD/Saturation Flats and Parcels pieces between 3.3 and 4.0 ounces for which the Postal Service has decided to forgo pound revenue. (This understanding is supported by the fact that in the section on "Carrier Route" the Postal Service identifies 1.2 billion pieces in this weight range.)

There are two, and possibly three problems, with the Postal Service's proffered rational which are so serious that they put into question the credibility of the Postal Service's representations as to its real reason for this proposal.

First, as stated above, the financial condition of the Postal Service is not such that it has any revenue to "give away" regardless of the amount involved. And, if it wanted to engage in a "give away" to flats mailers it could do so for some profitable flats products (*e.g.*, HD/Saturation Flats and Parcels) and not unprofitable products (*e.g.*, Standard Flats). The Postal Service never explains why flats mailers are deserving of this "give away."

Second, in stating its rationale here, the Postal Service jettisons the notion of "adding value" and focuses on "simplifying the rate structure" and the new argument — "growing mail volume." To the extent that these benefitted pieces are in Standard Mail Flats, this "growing mail volume" will result in more non-compensatory, money-losing pieces of mail. As the Postal Service strives to improve its financial condition, the last thing it needs is a surge in the volume of Standard Mail Flats, which on average lose about 10 cents per piece.[4] Since the Postal Service has no money of its own to give away, it is required to increase the burden on other profitable Standard Mail products to make up for these revenue losses — increasing the cross-subsidy required from its best customers. This necessary increase in profitable products — most especially HD/Saturation Letters — will cause that product to "lose value" and will cause a reduction in mail volume from this product with high elasticity.[5]

Here again, Postal Service pricing in no way resembles that of a private sector business, or even a rational monopolist, as it touts the benefit of growing mail volume from money-losing products, while being wholly unconcerned about losing mail volume from its most profitable products. This is irrational. The legal term for such behavior is "arbitrary and capricious." It violates numerous factors and objectives of the Act, including: (b)(2) (predictability and stability in rates), (b)(5) (assuring adequate revenues), (b)(6) (increasing the

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[4] The Postal Service is aware of this fact — "the volume of Standard Mail Flats actually grew in FY 2015, and when unit contribution is negative, **volume growth will necessarily increase the aggregate contribution shortfall**." Docket No. ACR2015, USPS Annual Compliance Report at 30 (emphasis added).

[5] *See* Letter from Daniel J. Foucheaux to Commission concerning estimated price elasticities (Jan. 20, 2016), http://www.prc.gov/docs/94/94740/Letter_DemandAnalyses_FY15.pdf.

transparency of the ratemaking process), (b)(8) (just and reasonable rate schedule), (c)(2) (bearing attributable costs plus a reasonably assignable portion of institutional costs), (c)(3) (effect of rate increases), (c)(6) (identifiable relationships between rates charged the various mail services). The Commission cannot approve these rates.

And there is a third possible problem. The amount of money that would be foregone from this proposal in no way justifies the noticed price decrease for HD/Saturation Flats and Parcels. To obtain a rough order of magnitude of "give away" being provided flats mailers, we have examined current rates (rounded) for Saturation Flats with no entry discount:

| weight | Current Price w/pound rate | Current Price w/o pound rate | Effect |
|---|---|---|---|
| 3.3 ozs. or less | 20.5 | 20.5 | unchanged |
| 3.4 ozs. | 20.9 | 20.5 | 0.4 |
| * * * | | | |
| 4.0 ozs. | 23.2 | 20.5 | 2.7 |

Assume that all of these 480 million pieces which will be benefitted by this proposal currently weigh 4.0 ounces, currently paying weight-based postage for the 0.7 ounces by which it exceeds the 3.3 ounce breakpoint. For the type of mail postulated here, the weight-based revenue loss for each piece would be 2.7 cents per piece. The total weight-based revenue loss for these 480 million pieces would be $12.9 million (480 million pieces x $0.027). The "give away" for other rate cells is different. For example, for Saturation Flats, DDU entry, the revenue loss is 1.75 cents, which for all 480 million pieces would be a total of $8.4 million.[6]

[6] In calculating current HD/Saturation Flats rates by rate increment, it seems that most High Density Plus Flats weighing 3.3 ounces or less may be paying a higher price than comparable but heavier pieces weighing up to 4.0 ounces, regardless of point of entry.

Based on this, we postulate that the total “give away” for HD/Saturation Flats and Parcels is **in the range of $10 million**.

However, in the language quoted above, the Postal Service represented to the Commission that: “This volume shift placed significant downward pressure on these price categories, **resulting in** an overall price decrease.” (Emphasis added.) This language seems to indicate that the noticed price decrease for HD/Saturation Flats and Parcels was due **entirely** to the increase in the breakpoint. However, according to the Postal Service’s price cap calculation, the noticed 2.1 percent decrease in prices for **HD/Saturation Flats and Parcels** will result in a **loss of revenues of $42.2 million** — an amount substantially greater than the postulated loss in revenue from the increase in the breakpoint weight postulated above. If correct, the implication of this estimate of money lost from an increase in the weight breakpoint is that the Postal Service noticed **decrease** in the price of HD/Saturation Flats and Parcels by 2.1 percent **was not, in fact, due to the increase in the weight breakpoint**. If these numbers are accurate, the increase in the breakpoint could have been employed to obscure the arbitrary nature of the price reduction, and the Commission cannot approve these prices. (We invite the Commission to examine the merit of this third possible argument based on data the Postal Service could be requested to provide.)

### E. An Examination of Changes in Unit Revenues Exposes the True Nature of the Postal Service’s Standard Mail Price Adjustments.

Perhaps the best way to achieve an apples-to-apples comparison of the effect of the prices noticed in this docket is to compare:

(i) the unit revenues generated by the noticed prices using the adjusted billing determinants (to account for FSS volume migration and the increase in the weight breakpoint), with

(ii) unit revenues as reported in the FY 2014 ACD — the last full year before the Docket No. R2015-4 FSS pricing changes caused volume shifts.

**Table II**

**Standard Mail Unit Revenues by Product**
**FY 2014 ACD & Noticed Prices**

| | FY 2014 ACD (cents) | R2017-1 (cents) | Change |
|---|---|---|---|
| HD/Sat Letters | 14.801 | 15.361 | 3.78% |
| HD/Sat Flats & Parcels | 17.824 | 17.920 | 0.54% |
| Carrier Route | 26.369 | 26.436 | 0.25% |
| Letters | 20.711 | 20.698 | -0.06% |
| Flats | 40.389 | 40.267 | -0.30% |
| Parcels | 109.358 | 114.828 | 5.00% |

This multi-year method of examining the results of Standard Mail pricing changes set out in Table II provides important context to assess the percent price changes by product as contained in the Postal Service's filing.[7] Table II reveals that only two products have born the brunt of the Postal Service's pricing authority over the span of the last two CPI-based dockets — this docket and Docket No. R2015-4. **Standard Mail Parcels** pricing appears to generate a

[7] Moreover, the FY 2014 unit revenues reflect the exigent surcharge that was implemented in January 2014 (*i.e.*, during nearly three-quarters of that fiscal year), and thus should be expected to be higher than current prices which might not have caught up to the exigent level. However, the exigent surcharge has expired and is not included in the prices proposed in this docket. This makes the comparison of the effect of the pricing adjustments even more surprising.

5.00 percent increase in unit revenue for that product — but that is understandable because it is underwater and has the lowest cost coverage of any Standard Mail product. **HD/Saturation Letters**, on the other hand, the Standard Mail product with the highest cost coverage, and one of the highest own-price elasticies, has seen price increases generating the next highest price increases.

Lastly, despite all assurance from the Postal Service about good faith compliance with the Commission's remedial order in the FY 2010 ACD, **Standard Mail Flats** appears to have enjoyed pricing which results in a **decrease** in unit revenue, some of which might be due to the expired exigent surcharge, but more likely relates to the barely above-average increases that product has received, despite increasing costs, and despite the clear Commission directives to increase its cost coverage. Viewed in this way over a multi-year period, the Postal Service's pricing decisions have resulted in pricing changes that actually have been counter-productive in solving the problem of underwater Standard Mail Flats, in blatant flouting of the Commission remedial order in FY 2010 ACD. Moreover, these pricing changes have exacerbated the problem of unfairly overcharging of the highest coverage Standard Mail product — HD/Saturation Letters.

These prices are arbitrary and capricious, in violation of the Commission's remedial order, in violation of the factors and objectives of PAEA, and in violation of 39 U.S.C. §§ 101(d) and 403(c) for the reasons set out in Valpak Comments in Docket No. ACR2015, pages 2-21, which are incorporated herein by reference. The Commission must disapprove the noticed price adjustments for Standard Mail.

## II. Standard Mail Flats Compliance.

In the FY 2010 ACD, the Commission ordered:

> Pursuant to section 3653(c), the Commission directs the Postal Service to **increase the cost coverage** of the Standard Mail Flats product through a combination of above-average price adjustments, consistent with the price cap requirements, and cost reductions **until such time that the revenues for this product exceed attributable costs**.
>
> * * *
>
> In subsequent Notices of Market Dominant Price Adjustments, the Postal Service shall report the following information:
>
> - an **explanation** of how the proposed prices will **move the Flats cost coverage toward 100 percent**, and
> - a statement **estimating** the effect that the proposed prices will have in **reducing the subsidy** of the Flats product.
>
> [FY 2010 ACD at 106-07 (emphasis added).]

The Postal Service's Notice in this docket provided the following, which the Postal Service claims complies with the directive:

> First, in a year when the average price increase for Standard Mail is 0.895 percent, the Postal Service is increasing the price of Standard Mail Flats by 2.493 percent. **Assuming** that the average cost per piece does not drastically change, the Postal Service **believes** that this year's above average price change for Flats will improve cost coverage by allowing revenue per piece to rise faster than cost per piece. Second, since the proposed price increase for Flats is larger than the proposed price increase for Standard Mail Letters (2.493 percent vs. 2.037 percent), the Postal Service **believes** that the cross-subsidy between these two products will be reduced. The above percentages are readily available from this notice and from file "CAPCALC-STD-R2017-1" in library reference USPS-LR-R2017-1/2. [USPS Notice at 26-27 (emphasis added).]

In response to an Information Request proposed by Valpak, the Postal Service provided scant additional information about future proposed price increases.

### A. The Proposed Minimal 2.493 Percent Price Adjustment Proposed for Standard Mail Flats Will Not Reduce the Subsidy to Standard Flats.

The Postal Service cursorily claims that the proposed prices "will move the cost coverage for Standard Mail Flats towards 100 percent" and reduce the subsidy of the Standard Mail Flats product. Especially in view of its long track record of erroneous predictions, this claim, unsupported by meaningful analysis, should not be considered compliance with the Commission's FY 2010 ACD directives an explanation and statement "estimating the effect" on reducing the subsidy and increasing the cost coverage.[8] However, the exact effect of the proposed price change for Standard Mail Flats on coverage has been obscured for at least three reasons, each of which is discussed below.

> First, because of the timing of this price adjustment, with FY 2016 having just ended on September 30, 2016, data on FY 2016 revenues, costs and cost coverage will not become publicly available until the Postal Service submits its ACR in late December. Consequently, at this time a critical appraisal of the Postal Service's assertions about the Standard Flats rate adjustment must use 2015 data to estimate the effect on reducing the subsidy and improving cost coverage.
>
> Second, changes to the price structure caused by eliminating short-lived FSS pricing requires that revised billing determinants be used to estimate both revenues and attributable costs to assess the revised price structure.
>
> Third, Commission Order No. 3506 (Sept. 9, 2016) requires that attributable cost now reflect incremental cost instead of marginal cost.[9] Any analysis of whether the Standard Mail Flats subsidy or cost coverage will go up or down under rates proposed to take effect in January 2017 should be based on incremental cost in FY2015 or, if available, in FY 2016. Analysis of a product's profitability (or losses) based on marginal cost is no longer permitted.

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[8] FY 2010 ACD at 107.

[9] "The Commission directs the Postal Service to use incremental costs as the basis for class-level and product-level attributable costs." Order No. 3506 at 125.

**1. Reduction in the subsidy using FY 2015 data.**

The maximum increase in revenue that can be expected from Standard Mail Flats, with no increase in FY 2015 volume, is around $53 million. As shown in Table 1, *infra*, **FY 2015** total Standard Mail Flats revenues were $2,106.2 million, and the **shortfall** between revenues and attributable (marginal) cost thus was **$521.7 million**. Standard Mail Flats volume has been declining gradually for several years. It would seem reasonable to assume that no increase in FY 2015 Standard Mail Flats volume will result from the slightly "above-average" price increase as proposed by the Postal Service. On this assumption, the maximum revenue effect that can be expected from a 2.493 percent price increase is an additional **$52.5 million** ($2,106.2 x 0.02493). Absent any change in volume, the most that Standard Mail Flats revenue possibly could increase would be from $2,106.2 to $2,158.7 million.

If the Standard Mail Flats subsidy were reduced by $52.5 million each year, the $521.7 billion subsidy in FY 2015 could be eliminated in about 10 years (actually, 9 years and 11 months). That would occur **about 16 years from the Commission's issuance of its remedial order in the FY 2010 ACD.** However, no comparison to FY 2015 can be relied upon because that year involved volumes for categories of mail which were migrated from Carrier Route and High Density/Saturation Flats & Parcels which have much lower unit costs (19.217 cents and 7.855 cents, respectively, in FY 2014 compared to 48.521 cents for Standard Mail Flats) and thus artificially inflated volumes and revenue for the latter one-third of FY 2015.

**2. Effect of FSS pricing change on volume and revenue.**

The Postal Service has proposed to discontinue all FSS pricing, which affects the billing determinants. Some of the volume previously recorded as Standard Mail Flats will be reclassified next year as Carrier Route and some as High Density/Saturation Flats and Parcels. Standard Mail workpapers in this docket indicate the Standard Mail Flats revenue will increase not by $52.5 million, but by $44,142,045, computed as follows from CAPCALC-STD-R2017-1.xls in USPS-LR-R2017-1/2:

| | | |
|---|---|---|
| LFP Revenue @ New Prices | $1,814,823,382 | in cell D159 |
| LFP Revenue @ Current Prices | $1,770,681,337 | in cell D166 |
| Change | $44,142,045 | |

Based on the volume of Standard Flats in the adjusted billing determinants for the hybrid year on which the cap calculation is based, the revenue per piece will be about 40.3 cents per piece. This is the same revenue per piece that Standard Flats had in FY 2014 — the last full year before the FSS pricing moved other volumes into that product. **Thus, even assuming no change in unit costs (an untenable assumption), this proposed price change will have no effect on improving the cost coverage and cross subsidy to Standard Flats.**

One can only conclude that the Commission's directive from the FY 2010 ACD has not motivated the Postal Service to take any meaningful steps to eliminate the cross-subsidy to Standard Mail Flats. Moreover, any assumption that costs will remain unchanged over the next decade is wholly unrealistic, which implies that elimination of the subsidy will take even longer than 10 years — perhaps much longer.

**3. Effect of Order No. 3506 and use of incremental cost to compute the subsidy.**

Order No. 3506 which mandated the use of incremental costs to determine whether products covered their costs was issued on September 9, 2016, slightly over one month before the Postal Service's notice of price adjustment was filed on October 12, 2016. Nevertheless, the Postal Service discussion makes no mention whatsoever of this fundamental change in the definition of attributable cost or the effect on cost coverage for, the deficit from, and the subsidy to Standard Mail Flats. The Postal Service filing is devoid of any estimate of incremental (attributable) cost based on this fundamental change.

Despite the failure of the Postal Service to provide any data or even analysis of the change in the definition of the marginal cost of Standard Mail Flats, we do know that adoption of incremental cost: (i) will have no effect on revenue as reported; but (ii) will increase to some unspecified extent attributable cost and the reported deficit (*i.e.*, the subsidy). If use of incremental cost causes the deficit to exceed that of FY 2015 or FY 2016, then the Postal Service is completely mistaken in its belief that the cross-subsidy between Standard Mail Flats and Standard Mail Letters will be reduced. Instead, using incremental cost rather than marginal cost can be expected to reveal that the true cross-subsidy is greater than ever because all prior estimates consistently understated the full cost which Standard Mail Flats causes the Postal Service to incur. And even the preceding estimates of the number of years required to eliminate the subsidy would appear to be highly unrealistic.

### B. The 2.493 Percent Price Adjustment Proposed for Flats Also Will Fail to Improve Cost Coverage.

A price increase would not, per se, be expected to affect unit costs or total costs, except perhaps by reducing volume. As shown in Table III, *infra*, the CRA indicates that attributable (marginal) costs for Standard Mail Flats was $2,627.9 billion in FY 2015. Using marginal costs, coverage was only 80.15 percent, which — to state the obvious — is a remarkable 19.85 percentage points below 100 percent (100.00 – 80.15 percent). However, removing the lower-cost FSS volume and returning it to Carrier Route and High Density/Saturation Flats & Parcels will cause the unit costs of Standard Flats to increase significantly after the price change is implemented.

For these reasons, the Commission cannot in any way rely on the Postal Service's statements as regards the effect of its proposed rate increase on Standard Mail Flats cost coverage and the subsidy to that product.

### C. The Commission Has a Duty to Evaluate Costs and Cost Coverage for Underwater Products Such as Standard Mail Flats, and to Assess Compliance with Its FY 2010 ACD Directives.

Any product whose revenue covers its attributable cost and also contributes to the Postal Service's institutional costs is generally considered to be compensatory, even if its contribution to institutional overhead cost is relatively small. For compensatory products, compliance with the price cap generally is all that the Commission is obligated to concern itself with in the compressed time frame of a market dominant pricing review.

However, revenue from underwater products by definition does not cover the costs which such products cause the Postal Service to incur for their processing, transportation and delivery.

Underwater products clearly are non-compensatory, and by no means can they be considered self-sustaining. A subsidy is needed to cover their attributable (incremental) cost. In the framework of a self-sustaining Postal Service with negative net worth, no borrowing capability, and no government appropriation, that subsidy necessarily must be extracted from some other mailers of market dominant products, whose postage is increased higher than otherwise would be necessary. This constitutes a violation of 39 U.S.C. § 101(d).

Underwater products detract from the Postal Service's profitability, erode the Postal Service's liquidity and weaken its balance sheet.

Underwater products present a threat to the ability of the Postal Service to carry out its statutory duties. *Se* 39 U.S.C. § 3622(b)(5). Consequently, proposed price adjustments for underwater products should receive separate special scrutiny. In particular, costs and cost coverage are highly pertinent considerations that deserve critical evaluation. This was recognized by the Postal Service pricing notice in this docket, which states:

> Pursuant to the Commission's order from the Annual Compliance Determination (ACD) Report for FY 2010, the Postal Service must, in each annual market dominant price adjustment, provide: (1) **an explanation of how the proposed prices for Standard Mail Flats will move the cost coverage for Standard Mail Flats towards 100 percent**; (2) a statement estimating the effect that the proposed prices will have in reducing the subsidy of the Standard Mail Flats product; and (3) all underlying workpapers and data used to respond to parts a and b. The responses below comply with this directive.
>
> First, in a year when the average price increase for Standard Mail is 0.895 percent, the Postal Service is increasing the price of Standard Mail Flats by 2.493 percent. **Assuming that the average cost per piece does not drastically change**, the Postal Service believes that this year's above average price change for Flats **will improve cost coverage by allowing revenue per piece to rise faster than cost per piece**. Second, since the proposed price increase for Flats is larger than the proposed price increase for Standard Mail Letters (2.493 percent vs. 2.037 percent), the Postal Service believes that the cross-subsidy between these two products will be reduced. [*Id.* at 26-27 (emphasis added).]

Despite this precatory language, there is an outstanding remedial order from the FY 2010 ACD which limits Postal Service pricing flexibility in this docket. The Commission has a duty to determine for itself whether the Postal Service complied with that directive, and if it did not, to reject the Postal Service's noticed pricing. The Postal Service has no "pricing flexibility" either to violate the Commission's remedial order or to violate the policies of Title 39.

### D. Previous Price Adjustments Have Done Little to Improve Flats Cost Coverage or Reduce the Subsidy to Flats.

The Commission issued its remedial order for Standard Mail Flats in the FY 2010 ACD in March, 2011. Table III, *infra*, shows how well the Postal Service has done in obeying the FY 2010 ACD during the years 2011 through 2015. (Of course, during the years shown in Table III, attributable costs as reported in the ACD reflected marginal cost, not incremental costs.)

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**Table III**

**Standard Mail Flats Revenues, Costs, and Losses Since FY 2010 ACD Remedial Order 2011 – 2015**

| | | | | | --------- PER PIECE --------- | | |
|---|---|---|---|---|---|---|---|
| Fiscal Year | Revenue ($, mill) (1) | Attributable (marginal) Cost ($, mill) (2) | Contri-bution ($, mill) (3) | Coverage (4) | Revenue ($) (5) | Attributable (marginal) Cost ($) (6) | Contri-bution ($) (7) |
| 2011 | 2,491.1 | 3,142.9 | -651.8 | 79.26% | 0.367 | 0.463 | -0.096 |
| 2012 | 2,228.6 | 2,761.7 | -533.1 | 80.70% | 0.375 | 0.466 | -0.090 |
| 2013 | 2,134.1 | 2,514.3 | -380.2 | 84.88% | 0.383 | 0.452 | -0.069 |
| 2014 | 2,037.4 | 2,497.0 | -459.6 | 81.59% | 0.403 | 0.494 | -0.091 |
| 2015 | 2,106.2 | 2,627.9 | -521.7 | 80.15% | 0.401 | 0.501 | -0.100 |

Source: Public CRA Report for each respective year.

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**1. Standard Mail Flats Coverage.**

The FY 2010 ACD, issued in March 2011, was around the midpoint of FY 2011, which gave the Postal Service little time to react to the Commission's directive in that fiscal year. However, it is now five and one-half years later. Coverage is shown in Table 1, Column 4. The improvement in coverage from 2011 to 2015 was an anemic 0.89 percentage points (80.15 percent – 79.26 percent), or an average increase of about 0.22 percentage points per year. At that rate, 100 percent coverage will be achieved in approximately **90 years** — *i.e.*, early in the 22nd Century.

Over the past three fiscal years, cost coverage actually declined by 4.73 percentage points (from 84.88% to 80.15%), despite repeated assurances by the Postal Service (made in each pricing and ACR docket) that coverage could be expected to improve. This decrease in coverage of course was exact opposite of the direction desired by the Commission's FY 2010 ACD directive. Should that diminution continue, the Postal Service **never** will achieve 100 percent coverage for Standard Mail Flats. This track record illustrates the necessity for the Commission to subject to close scrutiny the Postal Service's unsupported assertion that "this year's above average price change for Flats will improve cost coverage."

**2. Standard Mail Flats Subsidy.**

Year-to-year change in the total Standard Mail Flats subsidy has shown substantial variation. The negative contribution shown in Table III, Column 3 is the deficit, which is the amount by which Standard Mail Flats have been subsidized. Between FY 2011 and FY 2015 the deficit was reduced from $651.8 million to $521.7 million, or by $130.1 million — a yearly average of around $33 million. Since FY 2012, however, the deficit was reduced by only $11.4 million — a yearly average improvement of less than $4 million.

### E. Proposed Rates Are Likely to Cause Standard Mail Flats and Carrier Route Combined to Be Underwater.

Standard Mail Flats have been a non-compensatory product for many years. On the other hand, Carrier Route, which is mostly flat shaped pieces, has been a compensatory product consistently making contributions to operating profits; see Table IV, Column 3.

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**Table IV**

**Carrier Route Revenues and Costs**
**2011 – 2015**

| | | | | | --------- PER PIECE | --------- | |
|---|---|---|---|---|---|---|---|
| Fiscal Year | Revenue ($, mill) (1) | Attributable (marginal) Cost ($, mill) (2) | Contri-bution ($, mill) (3) | Coverage (4) | Revenue ($) (5) | Attributable (marginal) Cost ($) (6) | Contri-bution ($) (7) |
| 2011 | 2,222.0 | 1,647.8 | 574.2 | 134.85% | 0.238 | 0.177 | 0.061 |
| 2012 | 2,244.3 | 1,720.6 | 523.7 | 130.44% | 0.246 | 0.189 | 0.057 |
| 2013 | 2,372.6 | 1,778.7 | 593.9 | 133.39% | 0.250 | 0.187 | 0.063 |
| 2014 | 2,364.0 | 1,685.7 | 678.3 | 140.24% | 0.263 | 0.188 | 0.075 |
| 2015 | 2,236.8 | 1,706.6 | 530.2 | 131.07% | 0.270 | 0.206 | 0.064 |

Source: Public CRA Report for each respective year.

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The Postal Service pricing proposal would increase the rate for Standard Mail Flats (by 2.493 percent) while **decreasing** the rate for Carrier Route (by 3.09 percent). In other words the Postal Service seemingly would send price signals for flats in a such a manner as to discourage unprofitable Standard Mail Flats slightly while encouraging profitable Carrier

Route.[10] However, a reduction of 3.09 percent in FY 2015 Carrier Route revenues amounts to $69 million. This reduction exceeds the estimated maximum gain of $44.1 to $52.5 million from the increase for Standard Mail Flats. If combined volume were to remain unchanged, combined revenues likely would be slightly less than they were in 2015. In order for the combined product to make a positive contribution, the combined attributable cost would have to be lower than it was in 2015 — an unlikely prospect.

In the past, the American Catalog Mailers Association has claimed that most catalogers mail at both the Standard Mail Flats and Carrier Route rates, in varying proportions, and that when combined the result is compensatory, *i.e.*, catalogs require no subsidy.[11] *Combined* results for the five years 2011-2015 are shown here in Table V. It can be see from Column 4 that the hypothetical catalog "combined product" was non-compensatory in two years, and compensatory in three years.

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[10] Standard Mail has four major profitable products with coverage over 100 percent. Of those profitable products, Carrier Route has the lowest Coverage. It is interesting to note that the Postal Service wants to use its pricing flexibility to send a price signal designed to encourage the volume for Carrier Route, which had a positive coverage in FY2015 of only 131 percent, while concurrently increasing the rate and discouraging volume for HD/Saturation Letters, which has the highest positive contribution of 219 percent. Based on such irrational pricing, the Postal Service's requests (to Congress) for greater pricing flexibility should be rejected out of hand, and any Postal Service complaints about lack of funds to invest in new vehicles should fall on deaf ears.

[11] *See, e.g.,* Docket No. ACR2014, ACMA Initial Comments at 3-5.

**Table V**

**Standard Mail Flats & Carrier Route (combined) Revenues and Costs 2011 – 2015**

| Fiscal Year | Revenue ($, mill) (1) | Attributable (marginal) Cost ($, mill) (2) | Contri-bution ($, mill) (3) | Coverage (4) |
|---|---|---|---|---|
| 2011 | 4,713.1 | 4,790.7 | -77.6 | 93.38% |
| 2012 | 4,472.9 | 4,480.3 | -9.4 | 99.79% |
| 2013 | 4,506.7 | 4,293.0 | 213.7 | 104.98% |
| 2014 | 4,401.4 | 4,182.7 | 218.7 | 105.23% |
| 2015 | 4,343.0 | 4,334.5 | 8.5 | 100.20% |

Source: Public CRA Report for each respective year.

To the extent that most catalogers do mail some of their volume at proposed-to-be decreased Carrier Route rates, the Postal Service proposal is far removed from producing "rate shock." In fact, catalogers who enter a majority of their volume at Carrier Route rates may enjoy a net reduction in their cost for postage, whereas all those who mail using both products could have no increase at all. It is interesting to note that the Postal Service is providing such a break to the catalog mailers that provides the Postal Service with no contribution, while, forgive the expression, "sticking it to" the users of other Standard Mail products that are its most profitable.

The FY 2015 contribution from Carrier Route, $530.2 million, was just sufficient to offset the $521.7 million loss from Standard Mail Flats. The combined "profit" was a mere

$8.5 million, or 0.2 percent of combined revenue. Ignoring any volume effects from the proposed price adjustments would convert the combined profit into a slight loss.

Use of incremental costing as required by Order No. 3507 likely will result in these two products to cause a combined loss. Importantly, all cost data in Table IV and V are based on marginal (attributable) costs. Basing the analysis on FY 2016 incremental (attributable) costs doubtless would cause the combined contribution from Standard Mail Flats and Carrier Route to be negative, *i.e,* a loss. Furthermore, to the extent that it is informative to combine the revenues as shown in Table V and compare the result with costs, the comparison should be with the incremental costs of Standard Mail Flats and Carrier Route *combined*. The incremental cost of the related two categories combined may exceed the sum of the incremental cost of each individual category.

## F. Cost Cutting Will Not Improve Standard Flats Cost Coverage for Years to Come.

### 1. The FY 2015 ACD Determination of Noncompliance

In its FY 2015 ACD (Mar. 28, 2016), the Commission reiterated its determination in its FY 2010 ACD:

> that Standard Mail Flats prices in effect in FY 2010 did not comply with 39 U.S.C. § 101(d) and directed the Postal Service to increase the product's cost coverage through a combination of [i] above-average price adjustments, consistent with the price cap requirements, and [ii] cost reductions, until such time that revenue exceeds attributable cost. [FY 2015 ACD at 52.]

The Commission imposed no additional remedial measures for FY 2012, FY 2013, and FY 2014 because "the Commission found that the Postal Service had made progress towards addressing the issues raised in the FY 2010 ACD." *Id*. at 53. However, for FY 2015, the

Commission found that the "Postal Service did not fully comply with the FY 2010 directive in FY 2015" with respect to Standard Mail Flats. FY 2015 ACD at 53, 64. The Commission stated that it has "consistently recommended that the Postal Service improve the financial performance of flats products in" every ACD starting the FY 2008, but progress has been only "minimal." *Id*. at 64, 161. That noncompliance is continued in this price notice.

Irrespective of whatever cost cutting measures the Postal Service has attempted over a multi-year period, matters are getting worse. The price increase noticed in Docket No. R2015-4 was only 2.549 percent, not even keeping up with the 3.299 percent increase in unit costs. *See id*. Even then, the 2.549 percent was spread across not only the normal Standard Flats volume, but also to new FSS volumes that were migrated in from Carrier Route and HD/Saturation Flats and Parcels — and which are now being migrated back to those products in this docket.[12]

The Commission has regularly asked for the Postal Service to quantify its efforts to reduce flats costs, but in each annual compliance review, the Postal Service has been unable or unwilling to do so. Again, in Docket No. ACR2015, "although the Postal Service described new and ongoing operational initiatives employed during FY 2015 to make processing Standard Mail Flats more efficient, it was not able to quantify the financial effects of those initiatives." *Id*. at 64. Regardless of the actual effect of particular cost cutting efforts, unit costs continue to rise, while unit contribution from Standard Mail Flats continues to sink

[12] The Commission should reassess whether the actual increase for Standard Mail Flats in Docket No. R2015-4 (exclusive of the migrated FSS volumes) was actually above average, for it certainly appears that it was not — despite the Commission's directives.

deeper underwater, and "the cumulative shortfall in contribution from FY 2008 through FY 2015 has grown to **$3.9 billion**." *Id*. at 63 (emphasis added). *See also* Table III-9.

The Commission's determination in the FY 2015 ACD follows on the explicit finding of noncompliance in the FY 2010 ACD. There, the Commission found:

> Beginning as early as the FY 2008 ACD and reiterated in subsequent proceedings, the Commission expressed concern that **Standard Mail Flats** do not cover costs and, as a consequence, **impose a disproportionate institutional cost burden on other Standard Mail products**, particularly Letters. [FY 2010 ACD at 15-16 (emphasis added).]

The Commission continued:

> three commenters … claim that the intra-class subsidy, amounting to $1.4 billion over the last three years, including $577 million in FY 2010, **violates 39 U.S.C. 101(d)**…. **The Commission agrees** and concludes that the **Standard Flats product is not in compliance** with this important policy of title 39. [*Id*. (emphasis added).]

Over the years, the situation has worsened, the Standard Mail Flats product remains far out of compliance, and the Commission's remedial orders have neither resolved nor reduced the intra-class subsidy that exists.

Accordingly, the FY 2015 ACD directed the Postal Service to file a report within 120 days of the ACD providing information about the Postal Service's data systems "[i]n order to understand what can be done to improve cost and service efficiency for flats…." *Id.* at 181. The Commission concluded that it "will evaluate the Postal Service report and may use the information provided to form the basis of a **new proceeding** or **other appropriate action**." *Id*. at 182 (emphasis added).

The ACD identified six "pinch points" which are driving up costs as well as causing service performance issues:

- Bundle Sorting Operations
- Low Productivity on Automated Equipment
- Manual Processing
- Allied Operations Cost and Service Issues
- Transportation Operations
- Last Mile/Delivery

And, the Commission sought additional information because "[w]ithout visibility into the capabilities of the Postal Service's **current data systems** to track and measure the impacts of its operational initiatives intended to improve flats costs … flats will continue to be a **billion-dollar issue** for years to come." *Id.* at 164-65 (emphasis added).

**2. Postal Service Flats Report**

On July 26, 2016, the Postal Service filed a lengthy report in response to the Commission's directive where it once again demonstrated that it intends to do virtually nothing to stem their losses on underwater products unless forced to do otherwise by the Commission (hereinafter "Flats Report"). For Standard Mail Flats, the FY 2015 ACD directed the Postal Service to discuss its data systems covering the six "pinch points" set out above to shed light on problems related to (i) cost coverage and (ii) service performance. Where current data systems fail to provide information about these pinch points, the Commission asked what it would take to develop such data.

The Postal Service claims that it "shares many of the Commission's concerns about costs and service for flat-shaped products." Flats Report at 2. It states the obvious when it observes: "There is no doubt that Outside County Periodicals and Standard Mail Flats, in particular, have been **among the most challenging products** for the Postal Service to **process and deliver profitably** in the years since enactment of" PAEA. *Id.* (emphasis added).

The Postal Service explains that most of the service **performance** issues were caused by a one-time change made to the "operating window." The Postal Service claims that this one-time event is unlikely to be replicated, and thus, "calling into question the need for the present report, at least insofar as service issues are concerned." *Id.* at 2. However, the Postal Service makes no statement about whether this "one-time event" resulted in any improvement in cost coverage.

The Postal Service's report on Standard Mail Flats addresses in detail each of the six pinch points. Throughout the report, however, the Postal Service questions the ability of improved data to help resolve the issues. For each of the six pinch points, it describes "Information Generated by Current Data Systems," followed by a discussion of "Opportunities to Improve Current Data." The Postal Service attacks the Commission's remedial order, claiming that "'more data' as a stand-alone objective cannot improve the efficiency or service performance of flat-shaped mail" — as if the Commission ever claimed that "more data" was the objective. *Id.* at 3. Collecting more data on cost problems will not solve underwater Standard Mail Flats — prices need to be increased immediately and in a meaningful way.

The Postal Service gives lip service to the unsatisfactory situation with respect to cost and service performance of Standard Mail Flats by stating that it appreciates the Commission's concern. On the surface, the Postal Service response appears to be fully responsive — almost overly responsive — to the Commission request, drowning the Commission in irrelevant detail. For each pinch point it describes every existing data system along with a discussion of the strengths and limitations of each. However, when discussing opportunities to improve data the Postal Service goes into exquisite detail (i) about matters that would be prohibitively expensive to implement, and (ii) likely do little, if anything, to improve performance or productivity.

Although the Postal Service tries to give the impression it went out of its way to be responsive, it assiduously avoids the obvious. The low productivity, and high cost, of processing and delivery of flats relative to letters, due to a failure (possibly the inability) of automation — especially FSS — to reduce processing cost, especially the cost of processing mail presorted to carrier route. But that basic truth is not even hinted at in the Postal Service response. To elaborate, if Carrier Route flats (which are presorted to line-of-travel or walk sequence) can be manually sequenced for delivery by carriers at a lower unit cost than FSS operating at maximum speed and optimum capacity, then simply striving for better, more granular information is not likely to reduce cost. In fact, the Postal Service move to shift Carrier Route flats to FSS may be an important cause of the most recent increase in the unit cost of flats. The Postal Service Flats Report's only comment with respect to FSS is that it is still in its infancy. The truth is otherwise.

Data visibility, in theory, would help identify and resolve problem areas with Postal Service operations. However, after thinking about it for four months, the Postal Service has now confirmed that either it is unwilling or financially unable to develop data systems where they do not now exist.[13]

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[13] The Postal Service chooses to interpret the Commission's reasonable reference to an "ideal data system" to mean one that "capture[s] information about every mail piece processed through each operation" in a way that "would allow management to define desired operational flows for all mailed items through every facility configuration, detect deviations from the

The Postal Service Report sets out few priorities for reducing cost or improving service performance of flats. Indeed, the Postal Service puts the ball back into the Commission's court: "the Postal Service expects that **the Commission's reaction** to this information will be a significant contribution to subsequent efforts to reach the beneficial goals outlined in the Commission's pinch point analyses." Flats Report at 7. In other words, the Postal Service is telling the Commission to "fix it yourself."

### 3. Commission Information Request No. 1, Docket No. ACR2015

Two months after the Postal Service's Flats Report, the Commission issued Commission Information Request No. 1 (Sept. 27, 2016),[14] which stated:

> the Postal Service provided a response to the Commission's directive that **did not provide a method** to measure, track, and report the cost and service performance issues for each pinch point. Without a plan to measure, track, and report these issues, **the Postal Service has not complied** with the Commission's directive. [CIR No. 1 at 2 (emphasis added).]

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desired flow and allow the immediate rerouting of the errant piece and/or container [and] would be usable for identifying and then preventing the root causes of the failures." Flats Report at 9-10. The Postal Service continues describing something much more than an "ideal" system. Indeed, the Postal Service's "ideal data system" could even predict the future! *See id.* at 12. Once the Postal Service defines an "ideal data system" as being a pipe dream, it was simple for the Postal Service to conclude that it could not be achieved. *See id.* at 12-16. The Commission did not define an "ideal data system," and the Postal Service took the most extreme interpretation of that term possible. The Postal Service **could have** actually contributed to the conversation by describing an improved data system that would improve coverage and service performance in the context of the real world of Postal Service operations, but it chose not to do so.

[14] The Commission also hosted a technical conference on October 21, 2016 to allow the Postal Service to present its ideas on these issues.

That CIR graciously granted the Postal Service yet another 60 days to develop ideas how to measure and report on problem areas that drive up costs for Standard Mail Flats. That brings us to the present. Noncompliance with the FY 2010 ACD directive is still the order of the day. Fourteen months after the end of FY 2015, still no action has begun to deal effectively with the problems.

**4. Need for Effective Enforcement of Remedial Orders**

Title 39 does not allow the Commission to ignore this problem any longer. Once a determination of noncompliance is made, PAEA requires Commission to treat it identically to a situation where a complaint was filed and found justified. The Commission is to "order that the Postal Service take such action as the Commission considers appropriate in order":

1. "to achieve compliance with the applicable requirements and"
2. "to remedy the effects of any noncompliance." 39 U.S.C. § 3662(c).

Furthermore, the U.S. Court of Appeals for the D.C. Circuit has ruled that once the Commission finds that a complaint is justified, it becomes "**obligated**" by section 3662(c) to provide an "**adequate remedy**," one that fully redresses the wrong both by bringing the Postal Service into compliance with the law and by remedying any effects of prior noncompliance. *See* Gamefly, Inc. v. Postal Regulatory Commission, 704 F.3d 145, 149 (D.C. Cir. 2013) (emphasis added).

In Gamefly, the Commission "issued an order finding that the Postal Service was indeed discriminating against Gamefly," in violation of 39 U.S.C. § 403(c), which, in pertinent part, requires the Postal Service to "provid[e] services and … establish[] classifications, rates, and fees" that do not "make any undue or unreasonable discrimination among users of the mails." *Id.* at 148. But the D.C. Circuit ruled that **the Commission's "remedy left much of the discrimination in place**." *Id.* at 146 (emphasis added). Indeed, the remedial order issued by the Commission in the Gamefly complaint docket, Docket No. C2009-1, was inadequate as it "could still require GameFly to 'continue to generate more than double the contribution per piece than Netflix mail.'" *Id.* at 148. The D.C. Circuit ruled that the Commission's order was "arbitrary and capricious because it **left discrimination in place** without reasonable explanation." *Id.* at 149 (emphasis added). Vacating the Commission's order, the court remanded the case "for an **adequate remedy**," instructing the Commission that it "**must** either remedy all discrimination or explain why any residual discrimination is due or reasonable under §403." *Id.* at 149 (emphasis added).

Most of the Standard Mail Flats price increases have been only barely above average,[15] with cost reductions virtually non-existent. As a result, in the FY 2015 ACD, the Commission ordered the Postal Service to file a report within 120 days. The filing of such a report was not intended to end the matter, as the Commission stated that it "may use the information provided [in the report] to form the basis of a new proceeding or other appropriate action." FY 2015 ACD at 182. The Commission made a finding of noncompliance in the FY 2015 ACD, and indeed pointed out that it has "consistently recommended that the Postal Service improve the financial performance of flats products in" every ACD starting the FY 2008. *See id.* at 161.

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[15] The Postal Service repeatedly stated its definition of "above average" to be a paltry 5 percent (not 5 percentage points) above average. *See e.g.*, Response to ChIR No. 4, Q. 4 (Oct. 26, 2016).

The Postal Service's Flats Report of July 26, 2016 and subsequent filings have not been without value, however, as they conclusively prove that the remedy to underwater Standard Mail Flats cannot be found in cost cutting. A price increase for this underwater product is demanded by these facts as the violation of the FY 2010 ACD remedial order cannot continue unabated.

It must be remembered that the FY 2010 ACD pricing directive was not simply for barely above-average price increases for Standard Mail Flats. Instead, the directive was to increase the cost coverage for that product until it exceeds costs. As demonstrated above, the cost reduction portion of that remedy has been nonexistent — or entirely ineffective. And as the noticed prices for Standard Flats will produce a unit revenue the same as the unit revenue in FY 2014 (the last full year before the FSS pricing), the proposed prices will do nothing towards complying with the remedial order to improve cost coverage. These prices cannot be approved.

**G. Conclusion**

In this docket, the Postal Service made the following statement, which is unsupported by any analysis or detailed explanation:

> Assuming that the average cost per piece does not drastically change, the Postal Service believes that this year's above average price change for Flats will improve cost coverage by allowing revenue per piece to rise faster than cost per piece. [Notice at 26.]

As indicated above, the proposed 2.493 percent increase for Standard Mail Flats is expected to result in unit revenues of 40.3 cents — the same unit revenue for the Standard Mail Flats product before the FSS pricing in Docket No. R2015-4. **After 6 years, Standard Mail Flats is no closer to 100 percent cost coverage.**

The Commission must reject the noticed Standard Mail prices as not clearly demonstrating that they will improve the cost coverage of Standard Mail Flats as directed by the Commission over five years ago (and as urged by the Commission beginning eight years ago). Bare above-average price increases for Standard Mail Flats have proven inadequate in resolving the cross-subsidy, and even if considered "technical compliance," should not be treated as achieving the prime directive of the FY 2010 ACD — "to increase the cost coverage of Standard Mail Flats … until such time that the revenues for this product exceed attributable costs."

The Postal Service's noticed pricing places responsibility to end this illegal pricing scheme squarely back on the shoulders of the Commission one more time. The Postal Accountability and Enhancement Act did not grant the Postal Service the pricing flexibility to notice illegal prices or to violate a Commission remedial order. The noticed prices for Standard Mail must be rejected.

## III. Workshare Discounts.

### A. Standard Mail Destination Entry Discounts Are Fully Justified.

In Docket No. ACR2014, the DSCF dropship discount for Standard Mail letters had a reported passthrough of 57.4 percent. FY 2014 ACD, Table II-4, p. 18. One year later, in Docket No. ACR2015, the passthrough for DSCF dropship discount for Standard Mail letters had undergone a dramatic change to 225.0 percent. FY 2015 ACD, Table II-5, p. 25. The Postal Service "explains" this change in passthrough as follows:

> The passthrough for DSCF Letters compared to Origin Letters is 225 percent for FY 2015. This reflects a discount of 4.5 cents and a cost avoidance of 2.0 cents. As with Carrier Route, the cost avoidance in FY 2014 was 3.8 cents, nearly twice as high as the 1.6 cents cost avoidance in FY 2015. **The unexpected increase [sic] in cost avoidance resulted in the higher FY 2015 passthrough.** Cost avoidances for each fiscal year are estimated after the end of that fiscal year. [USPS FY 2015 Annual Compliance Report at 40 (emphasis added).]

From FY 2014 to FY 2015, the "unexpected" change in reported cost avoidance was actually a decrease, not an increase, *i.e.*, measured cost avoidance went from 3.8 cents in FY 2014 to 2.0 cents in FY2015. Given the extent of the change in passthrough from well under 100 percent to 225 percent, any attempt to adjust the passthrough immediately so as to reflect 100 percent of costs avoided would result in a high degree of rate shock for those mailers who have built their operations around availing themselves of a meaningful DSCF entry discount — an exception to the rule set out in 39 U.S.C. § 3622(e).

The Postal Service Notice indicates that the entry discount for DSCF letters would achieve a passthrough of 155.0 percent, down from the 225.0 percent reported in the FY 2015 ACD. In this docket, the Postal Service thus proposes to take a rather large step towards having destination-entered Standard Mail rates reflect 100 percent of **costs avoided** and is reasonable.[16] Moreover, any reduction in destination entry discounts that leads mailers to

[16] If the existing disparity between the current rate and DSCF discount for letters and the cost target is 2.5 cents, or 100 percent, the Postal Service's proposed discount of 3.0 cents would eliminate 56 percent of the disparity between the existing rate and the cost target.

forgo drop ship entry deep into the postal network, likely could have the unintended consequence of clogging the network, causing a deterioration in service performance for all Standard Mail.

### B. The Commission Should Reconsider Whether High Density Prices Are a Workshare Variant of Carrier Route Basic.

Chairman's Information Request No. 2 (Oct. 18, 2016), Question 2 (parts b. and c.) asked the Postal Service to resolve certain Nonprofit High Density letters and flats. The Postal Service's response (Oct. 25, 2016) states that:

> the Postal Service does not believe that the price differences between the Carrier Route and High Density price categories (commercial and nonprofit) should be considered workshare discounts. Unlike workshare discounts, which involve mailers performing activities that the Postal Service would otherwise have to perform itself, a customer's decision to enter Carrier Route or High Density mail reflects mail density. Thus, a mailer's ability to access High Density or Carrier Route rates is not based on the amount of additional work the mailer performs for the Postal Service — it is simply a matter of the number of delivery points that the mailer is able to reach. While the Postal Service understands that this issue was presented in Docket No. RM2009-3, it urges the Commission to give renewed attention to this matter in a future proceeding.

Valpak agrees with the Postal Service's response that High Density prices do not reflect any type of workshare activity that is being done instead of the Postal Service. The four statutorily defined types of workshare activity — "presorting, prebarcoding, handling, or transportation of mail" — do not encompass the difference between Carrier Route and High Density, which is only the density of the number of pieces per carrier route. The only economic efficiency that is experienced by a mailer qualifying for High Density is a greater number of pieces.[17]

In Order No. 536 (Sept. 14, 2010), the Commission concluded that "High Density and Saturation mail serve separate markets. Accordingly, section 3622(e) does not apply to the rate relationship between these two categories of mail." *Id.* at 59. Similarly, High Density and Carrier Route Basic serve different markets, and that is the only difference the Commission should recognize as between those categories. Moreover, the Commission can resolve that issue now, without the need for a separate, future proceeding.

Respectfully submitted,

/s/

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[17] *See* Docket No. RM2009-3, Valpak Reply Comments on Worksharing Issues in Response to Order No. 243 and Notice of Inquiry No. 1 (Sept. 11, 2009).