

BEFORE THE  
POSTAL REGULATORY COMMISSION  
WASHINGTON, DC 20268-0001

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Annual Compliance Report, 2016 )  
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Docket No. ACR2016

**INITIAL COMMENTS OF THE  
AMERICAN CATALOG MAILERS ASSOCIATION (ACMA)**  
(February 2, 2017)

Pursuant to Commission Order No. 3717, “Notice of Postal Service’s Filing of Annual Compliance Report and Request for Public Comments” (Dec. 30, 2016), ACMA is pleased to submit these comments, with workbook ACMA\_ACR2016\_Workbook.xlsx (hereinafter “Attachment”).

**I. Introduction**

Catalogs are generally mailed as flats, in a continuum composed of the Commercial (as opposed to the Nonprofit) parts of Standard Flats (SF), Carrier Route (CR), High-Density Flats, High-Density Plus Flats,<sup>1</sup> and Saturation Flats (Saturation).

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<sup>1</sup> Hereinafter, the term “High-Density Flats” or “High-Density,” or the initialism HD, is used to refer to the combination of High-Density Flats and High-Density Plus Flats. Readily available data do not allow these two to be considered separately. The term “High-Density Parcels” is used to refer to the combination of High-Density Parcels and High-Density Plus Parcels.

Together, these 5 groups were composed in FY 2016 of 17 Commercial categories and 17 Nonprofit categories. Most catalogs qualify for an IMb discount. Most SF catalogs qualify for its 6 automation categories. Many catalogs are dropshipped, and receive associated discounts. A majority are co-mailed. Most are on pallets. Some are sent as Bound Printed Matter (BPM). Catalogs are linked to other mail categories, including parcel categories used for fulfillment. Postal regulations exist for each category, and usually frame the categories that may be used. Volumes mailed usually depend on a weighted average of the rates of a group of categories, and circulation volumes are determined by the cost to reach the incremental customer.

Through catalogs, our members offer a wide range of goods and services, some of which are otherwise difficult to find. Postal rates are of considerable importance to catalogers and represent a significant portion of the cost of marketing. Cost to reach an incremental customer compared to the expected return therefrom drives circulation decisions, making catalog marketers extremely sensitive to costs, including postage, which now represents two-thirds of the incremental cost to reach customers.

## **II. Revenue and Cost Results for FY2016**

As laid out in Section I above, the rates paid by catalogs are a non-simple mixture, drawn from a roster of Postal Service categories and sub-categories. For cost reporting purposes, the Postal Service focuses on a limited number of composites. First, High-Density Flats, High-Density Parcels, Saturation Flats, and Saturation Parcels are combined and reported as a unit. A small number of catalogs are sent in the first and third of these. Second, Carrier Route (a large category) is reported separately from

Standard Flats (a small category dwarfed by the splitting off of CR).<sup>2</sup> Below these three foci, special cost studies are done to split costs further, mainly to support discounts for worksharing.

A perennial problem is that the costs and cost coverages reported are in all cases (except BPM) weighted averages for Commercial and Nonprofit mail. Because Nonprofit rates are considerably lower than Commercial rates, the cost coverages for Commercial mail are higher than the reported figures.

In reply comments in Docket No. ACR2015, ACMA explained that the history of the Nonprofit rates, including guiding legislation, is consistent with all mailers together funding the Nonprofit rates (at 8-14). Further, it is difficult to square the behavioral characteristics of the current arrangement with the apparent intent of Congress.<sup>3</sup> In its FY 2015 ACD (at 77), the Commission responded to these matters by saying that ACMA could “petition the Commission to consider such issues in another proceeding.” However, for purposes of assessing the rates being paid by the Commercial mailers and by catalogers in particular, no changes are needed and there is no bar to considering the cost coverages presented below.

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<sup>2</sup> Before Docket No. MC95-1, a category called Bulk Rate Regular (BRR) included Standard Letters (SL), SF, and Standard Parcels. Essentially, CR was split off from BRR in that docket. CR at that point contained a large number of letters. Then the 5-digit automation rate in SL became lower than the CR rate, so nearly all letters moved to SL. CR now includes a small number of letters and parcels.

<sup>3</sup> For example: The requirement is that the per-piece revenue of the Nonprofit categories be 60 percent of the per-piece revenue of “the most closely corresponding regular-rate [i.e., Commercial] subclass.” Section 3626(a)(6)(A). This implies that a relative-to-Commercial increase in Nonprofit worksharing must lead to a relative-to-Commercial increase in Nonprofit rates. Also, if Nonprofit rates are guided by the cost coverage of a category that includes both Commercial and Nonprofit, an increase in Nonprofit volume would lead to a rate increase for both Commercial and Nonprofit.

Because Standard Flats functions in considerable degree as a residual category to Carrier Route, tied by density proportions and co-mailing activities, the combination of the two is the most relevant to catalogs. And using the estimates in USPS Library Reference 27, Commercial can be separated from Nonprofit. Cost coverages for the resulting categories are shown in Table 1. Corresponding percentages for FY 2015 are shown in brackets.

<b>Table 1</b>	
<b>Commercial Cost Coverages FY 2016 [FY 2015]</b>	
Standard Flats + Carrier Route	<b>105.1%</b> [108.9%]
High-Density + Saturation, Flats and Parcels	<b>172.5%</b> [177.8%]

On this basis, catalogs cover their costs. An increase in the volume of catalogs, which would involve Standard Flats, Carrier Route, and a small portion of High-Density and Saturation, would increase net income.<sup>4</sup> A rate increase for Standard Flats alone would affect SF, CR, and co-mailing activities.<sup>5</sup> We believe the Postal Service is concerned about these relationships, as it should be. The rate relationships among these categories that we would prefer might be different from the ones the Postal Service would prefer, but we understand its interest in having a degree of flexibility.

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<sup>4</sup> For ratesetting and rate assessment purposes, volume changes considered should be of the kind and character that would be induced by a rate change. This kind of volume change is often referred to as a “rate-induced” volume change.

<sup>5</sup> No information is available on the cross-elasticity between Standard Flats and Carrier Route. See USPS demand equations submitted January 20, 2016. It is clear, however, that the two categories are connected by more than ordinary consumer preference.

The cost coverages for 2016 are somewhat below the 2015 figures, explained in part by the removal of the exigency surcharge. Beyond this, the reduction for SF+CR may be associated with the FSS, as discussed further below. For High-Density, we noticed a 76.2 percent increase in unit mail processing costs, shown in USPS Library Reference 18.

Though indicative in and of themselves, as we have explained, the figures in Table 1 are relatively aggregate. As shown in Table 2, they can be disaggregated.

<b>Table 2</b>			
<b>Flats-Category Cost Coverages FY 2016 [FY 2015]</b>			
	Commercial	Nonprofit	Product Total
Standard Flats	<b>86.7%</b> [88.6%]	<b>53.4%</b> [52.9%]	<b>79.7%</b> [80.2%]
Carrier Route	<b>140.7%</b> [134.7%]	<b>95.3%</b> [88.8%]	<b>137.5%</b> [131.1%]
High-Density + Saturation	<b>172.47%</b> [177.8%]	<b>94.6%</b> [94.5%]	<b>168.4%</b> [173.3%]

These results must be interpreted in the light of the volume reduction of CR, most of which moved to SF due to the FSS requirements. Table 3 shows the volume changes.

<b>Table 3</b>			
<b>Percentage Changes in Volume from FY 2015 to FY 2016</b>			
	Commercial	Nonprofit	Product Total
Standard Flats	<b>+24.1%</b>	<b>+5.9%</b>	<b>+20.2%</b>
Carrier Route	<b>-19.0%</b>	<b>-30.2%</b>	<b>-19.9%</b>
High-Density + Sat	<b>-1.3%</b>	<b>-6.8%</b>	<b>-1.6%</b>

In CR, Nonprofit volume decreased much more than Commercial volume (-30.2% compared to -19.0%). This should increase the coverage of CR somewhat. The bigger effect, however, would be expected to be the Commercial reduction of 19.0 percent, which is the primary cause of the volume increase for SF of 24.1 percent.

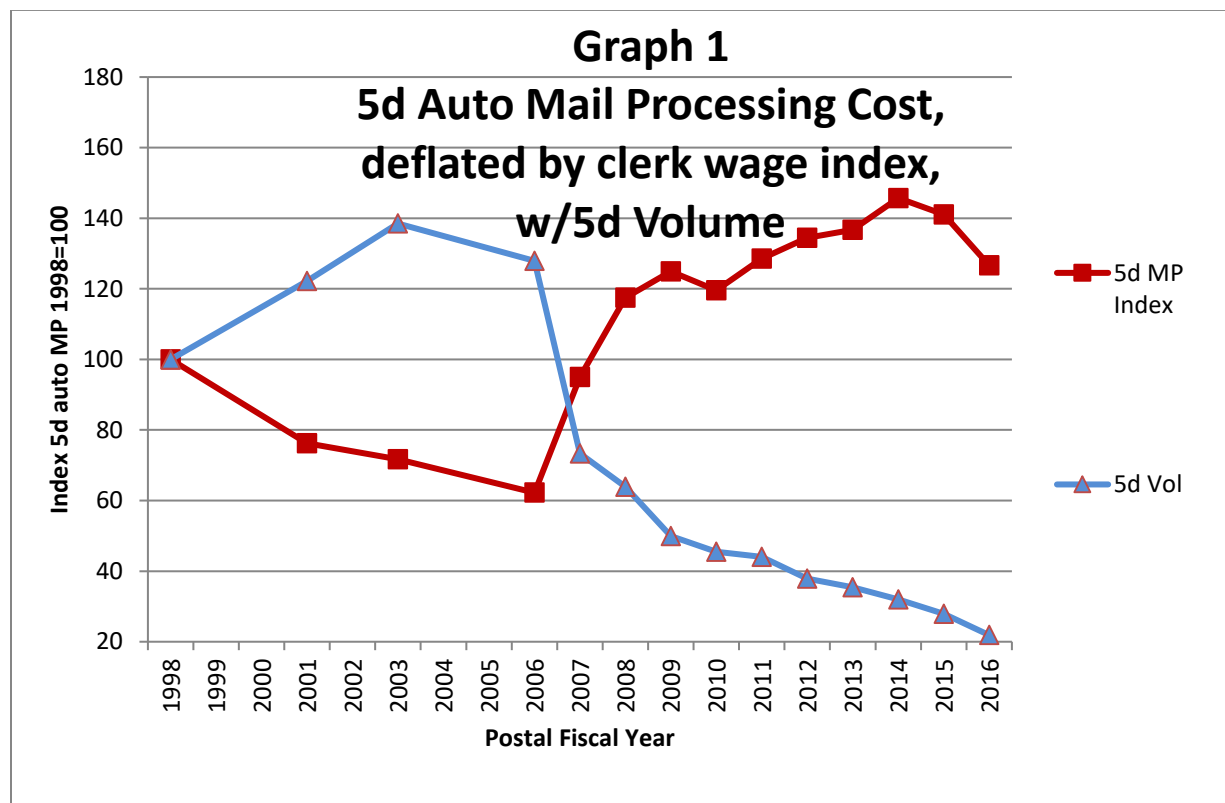
The FSS machines were installed in high-volume destinations. We would expect pallets to these destinations to be relatively heavy and the bundles on them to have a relatively large number of pieces. The mailings might have other low-cost characteristics that too are not recognized in rates. Therefore, we would expect the CR mail shifting to SF to be relatively high-coverage mail. Despite this, Table 2 shows that the cost coverage of CR increased by 6.4 percentage points (from 131.1% to 137.5%), much more than the decline in the Nonprofit volume accounts for, and this occurred in the face of a net rate decline. Most of this is explained by a 15.7 percent decline in unit mail processing cost (comparing costs developed in USPS Lib. Ref. 18). We hope this means that the Postal Service is tightening the associated mail processing operations.

We found one other relation that suggests progress. In FY 2015, the mail processing cost of automation 5d flats was 17.9 cents per piece above the mail

processing cost of Carrier Route, and in 2016 it was 16.0 cents above. This is a reduction of 1.9 cents per piece. We hope that this too indicates a tightening of operations, maybe aided by improved mail preparation, and that it continues. However, being for what should essentially be one sort on an AFSM 100, both differences are much too large.

### III. Further Review of Certain Cost Behaviors Suggests That the Associated Costs Cannot Be Relied on as Meaningful

In FY 2008 through FY 2014, before the establishment of the FSS categories, automation 5d accounted for an average of 64.4 percent of Standard Flats volume. Attachment, tab 4. For 1988 and since, we assembled the unit costs of mail processing for this category and deflated them by a clerk wage index. In index form, along with a corresponding volume index, the result is shown in Graph 1. Attachment tab 4.5.



This cost declines about 40 percent to 2006, then more than doubles to 2014, and then declines 19 percentage points to 2016. But the upward swing after 2006 is actually larger than shown, because the unit costs for 1998 through 2006 are for the former 3/5-digit presort category, which would have a higher cost than the 5-digit category in 2007 through 2016. These results raise serious questions about the meaningfulness of the costs involved. Further, it is neither effective nor fair to allow rates to fluctuate in substantial degree just to reflect such costs.

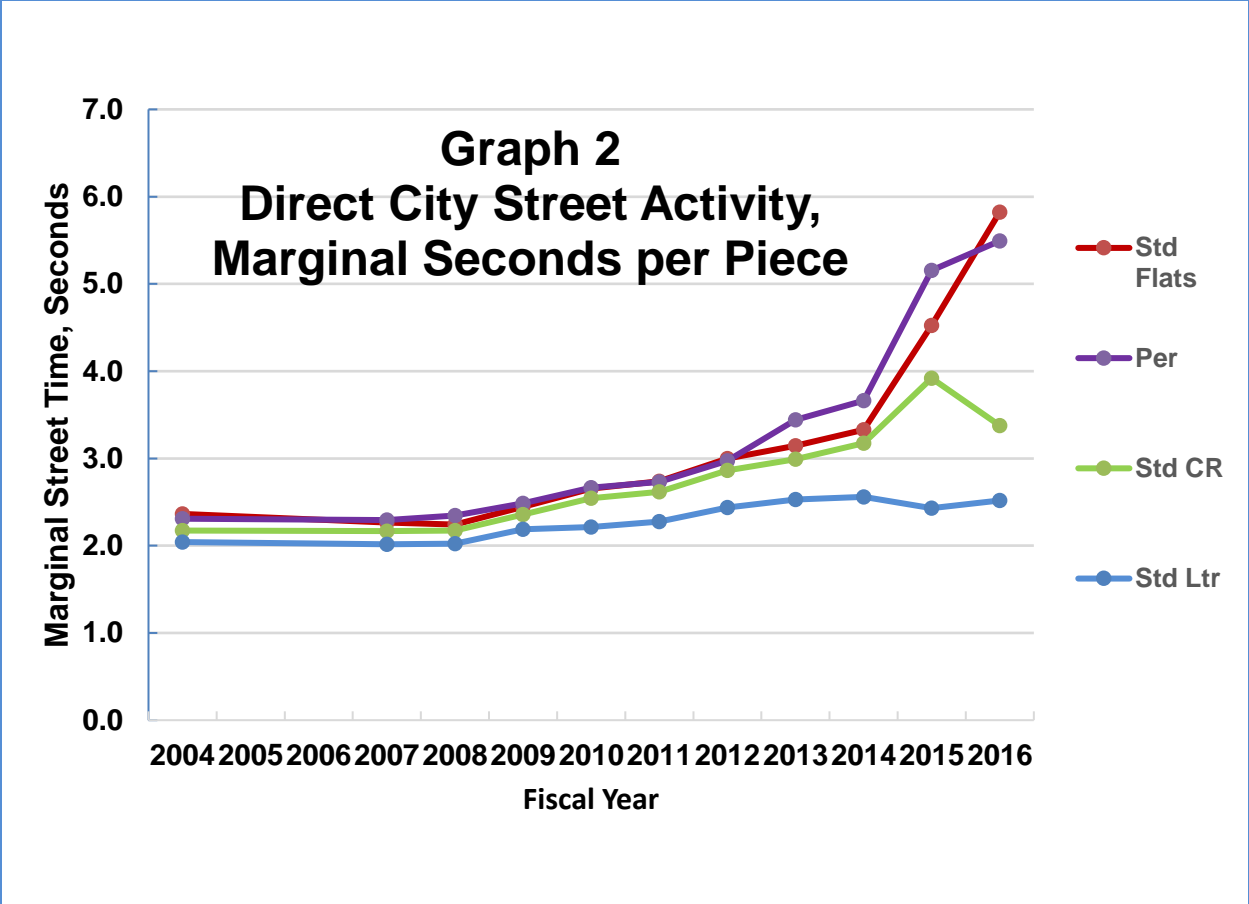
It has been commonplace to argue that unit costs move inversely with volume, due to scale effects. With the exception of a few years, a rough inverse relation exists in Graph 1. However, this is not an acceptable explanation, for the costs involved here are viewed and developed as nearly 100 percent volume-variable. If they are fully volume-variable, there can be no scale effects. If they are not fully volume-variable, then the attributable costs are too high and should be reduced. Either way, the costs being reported are unreliable.<sup>6</sup>

In a second step, we looked at the marginal street time in seconds per piece for city carriers. We began with the cost of the direct street activities (cost segment 7.2), without any street support activities or piggyback costs, and used a carrier wage to convert them into seconds of time. The results are shown in Graph 2. Attachment tabs 7 and 7.5.

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<sup>6</sup> Note that if it were found that the costs are not fully variable with volume, say they are found to be 75 percent variable, there would be no basis for assuming that the 75-percent figure remains unchanged as volume changes. The marginal cost would have to be found at the new volume level and an associated percent volume variability would have to be calculated. If marginal costs are to be found, there is no way to avoid asking the marginal-cost question.





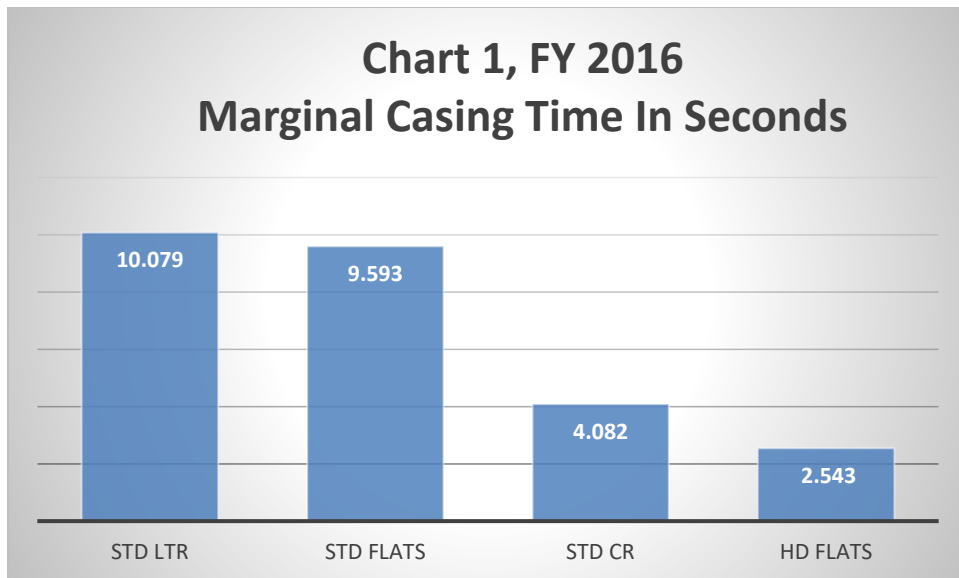
In 2004, an additional SF piece was estimated to cause additional street time of 2.4 seconds (letters were less at 2.0 seconds). This covers picking through an additional flat (or one less) in a flats case at a stop, and handling an additional tray when the volume change is large (which is a minimal amount of time on a per-piece basis). Analysts of carrier operations at the time presumably thought these results to be reasonable. By 2014, the time to handle an additional SF flat increased to 3.3 seconds, a 37.5 percent increase. Then in 2015, under the new carrier costing system, it increased to 4.5 seconds, and in 2016 to 5.8 seconds (a 28.7 percent increase over 2015). One wonders if the same analysts of carrier operations think each of these more-recent outcomes to be reasonable. In other words, how could a student of carrier

operations think an additional 2.4 seconds to be reasonable in 2004 and an additional 5.8 seconds to be reasonable in 2016? Keeping in mind that these costs get multiplied by tens of billions of pieces and by piggyback factors, the effect of such increases is very large.

Another question is raised by comparing the results for SF with the results for CR and HD. An additional CR piece in 2016 took an additional 3.4 seconds and an additional HD piece took an additional 2.6 seconds, both substantially below the result for SF. As we understand it, HD pieces are cased and perhaps FSS'ed. It is not clear that a carrier on the street can tell the difference between an HD piece, a CR piece, and an SF piece. Something certainly appears to be terribly wrong.

These findings on street time are disturbing. We have heard it suggested that carriers at stops are now spending substantial amounts of time fingering through trays of DPS'ed letters, FSS'ed flats, cased flats (including letters, which hardly stack well with flats), HD mailings, piles of saturation mailings, Every Door Direct Mail, and parcels, scanning some and not scanning others. It appears that all this activity is causing a substantial increase in the cost of Standard Flats, though it is unclear why it should be. In a stand-alone operation for flats, to be discussed in the next section, it seems doubtful that an additional flat would take more than an additional second or two.

Finally, we looked at direct casing costs, with no direct non-casing costs and no piggyback costs, and converted them into seconds. Attachment tab 6. For 2016, the results are shown in Chart 1.



The additional time to case an additional letter rounds to 10.1 seconds and to case an additional SF flat to 9.6 seconds (the latter 14.4% longer than in FY 2015). In a vertical flats case, into which letters and flats are cased together, it may be that these two times should be about the same, as they are. But 10.1 seconds is much too much time. If the old 18-and-8 standard were applied here (to a vertical flats case), the standard would be much closer to 18 (3.3 seconds) than 8 (7.5 seconds).

To gain further insight into casing time, we considered the marginal casing times for CR (which is in line-of-travel (LOT) sequence) and HD (which is also LOT, some of which is handled on the street as an additional bundle). These too are shown in Chart 1. As before, these are direct casing times and the volumes used are the volumes that were cased.

For 2016, we found the additional casing time for a CR piece to round to 4.1 seconds. Relative to this, SF takes 2.5 times as long ( $10.079/4.082$ ). The feature of CR that makes it take less time is LOT. A study done by the Postal Service found that

non-LOT flats take about 1.52 times as long to case.<sup>7</sup> Thus, the SF time is too far above the CR time. But even this CR figure may be too long, for the corresponding time for CR in 2007 was 3.2 seconds.<sup>8</sup> Next we looked at HD, and found the additional time to case an HD flat to round to 2.5 seconds. CR should be above this, but not as high as 4.1 seconds. The suggestion is that the casing time for CR is too high and for SF is much too high. In a stand-alone operation, a time on the order of two to three seconds might be acceptable, but a time on the order of 10 seconds would not.

#### **IV. The Stand-Alone Cost Test Argues Against Rate Increases for Flats**

The stand-alone cost test reasons that, were there no barriers to entry, if a competitor could build a specialized productive system, tailored to the provision of a product (or product group), and provide that product at a price lower than that of a regulated monopolist, then the monopolist is charging too much for the product.<sup>9</sup> In effect, the customers buying the product are being held captive by the monopoly while

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<sup>7</sup> See USPS-LR-I-307, Docket No R2000-1, provided in response to MPA/USPS-47, April 18, 2000, particularly at 4.

<sup>8</sup> The 2007 figure was developed from total CCCS volume instead of cased volume. Since the FSS did not have an effect until 2008, the two volumes should be about the same. The FY 2006 USPS Annual Report states that the FSS will have an effect in FY 2008 (at 6).

<sup>9</sup> For a discussion of Stand-Alone Cost in a railroad context, see "Railroad Regulation, Shipper Experiences and Current Issues in ICC Regulation of Rail Rates," GAO/RCED-87-119, Chapter 4. Because railroads have shareholders and are therefore profit-seeking organizations, the stand-alone test is applicable in a more limited way than in the Postal Service.

Stand-alone costs have also been discussed before the Commission. For example, see Direct Testimony of William J. Baumol on Behalf of United States Postal Service, USPS-T-3, Docket No. R87-1, May 7, 1987, *espc.* at 24.

the competitive system stands ready to provide the product at a lower price. This is unfair and is out of line with the efficient production of products that customers need.

In initial comments in Docket No. ACR 2015 (at 5-8), ACMA explained why it is reasonable to believe that the rates for flats, potentially including First-Class Flats that do not require a high service level, Standard Flats, Carrier Route, High-Density, and Saturation, are likely above their stand-alone cost, and we include that explanation here by reference. This means, at the least, that rate increases for these categories should be restrained.

Competition from a stand-alone operation could occur only in the absence of the Private Express Statutes (which apply only in limited degree to catalogs and not at all to Saturation pieces without addresses) and the mailbox rule. But these are nothing more than barriers to entry, which are on-purpose assumed away for the stand-alone test.<sup>10</sup>

It should not be assumed that a low stand-alone cost (which includes a normal return on investment) is an indication of postal inefficiency, although it could be. The Postal Service could build a stand-alone operation for flats, tailored to the needs of flats mailers, which could easily be met with three-day delivery. The justification for not keeping flats operations separate involves the possibility of economies of joint production. It is not clear to ACMA that flats are benefitting from any such economies, with or without the FSS.

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<sup>10</sup> In reply comments in Docket No. ACR2015, Valpak reasoned that “ACMA’s speculative argument bears little relation to reality, for the mailbox rule is not about to be relaxed” (at 5). But since the stand-alone test is blind to barriers to entry, Valpak’s concern is irrelevant. Valpak also argues that “(t)he mailbox rule is a critical part of the Postal Service’s statutory monopoly” (at 4). Actually, the mailbox rule is part of the Criminal Statutes (18 U.S.C.), not the Private Express Statutes.

## V. In the Delivery System Offered by the Postal Service, Neither Catalogs Nor Flats Generally Have Fared Well in Recent Years. Some Changes Are Sorely Needed

In 1998, the President was talking in glowing terms about a bridge to the 21<sup>st</sup> century. The cost coverage of Standard Flats was 102.5 percent. Its volume was a healthy 57.4 percent of the sum of Standard Flats and Carrier Route. The thoughts were that the Postal Service would continue investing in new technologies and that mailers would prepare mail to make the technologies effective. The future, it was thought, held lower rates and a greater role for the Postal Service.

The Postal Service did invest in new technologies, including a flats sequencing system, and mailers did invest in mail preparation, including advanced barcodes and greater use of pallets. At the same time, the prices paid by the Postal Service for the factors of production increased 64.5 percent and the rates for Standard Flats increased 88.1 percent. Under these conditions, one would expect the contribution from Standard Flats to increase.

But the results did not align with this expectation. The unit costs of Standard Flats, corrected for mix changes, increased 141.7 percent,<sup>11</sup> 77.2 percentage points more the factor price increase.<sup>12</sup> Despite the rate increase, this has led to a cost coverage of 79.7 percent and a Standard Flats volume that is now only 38.8 percent of the sum of SF and CR. Attachment tabs 3 and 1.

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<sup>11</sup> See ACMA cost index, Attachment tab 3. For further review of the index, see "Initial Comments of the [ACMA]," Docket No. ACR2014, Feb. 2, 2015, at 5-7, included here by reference.

<sup>12</sup> For letters, the cost index is **below** the factor price index, flip-flopped from flats. Attachment tab 8. Somehow, flats seem to be bearing the brunt of cost increases.

If the cost reduction from the technology improvements is assumed equal to the cost increase due to the new costing methods, these results argue that the costs increased 77.2 percentage points more than they should have. What is wrong?

Part of the answer is questionable costs, indications of which are discussed at the end of Section II and in Section III. Beyond such questions, the conventional wisdom is that volume declines have caused economies of scale to be lost. But this cannot explain a gap of 77.2 percentage points, especially in the cost categories that are 100 percent volume-variable, because, at a fundamental level, the Postal Service has not changed its scale. The scheme of carrier operations is the same as before, with fewer pieces and less travel time.<sup>13</sup> Mail processing is much the same, fewer machines but no change in scale. The explanations provided usually point to second-order things, such as scheme changes. Much more is needed. One cannot simply fit a curve to increasing costs and call it scale.<sup>14</sup>

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<sup>13</sup> In reply comments in Docket No. ACR2014, the Postal Service explained that “variations in marginal times arise not because of economies of scale, but because of economies of density” (at 25). ACMA does not argue that the marginal cost curve should be perfectly horizontal, but the explanation of the Postal Service is misguided, as economies of density usually focus on unit costs of the fully-distributed kind, which are not at issue here.

In the same reply comments, the Postal Service states that “ACMA’s analysis is ... oblivious to” increases in the number of potential delivery points (at 25). But the volume change relevant to the marginal-cost question is a rate-induced volume change. Since a rate change would not cause a change in the number of potential delivery points, the Postal Service’s concern is irrelevant.

<sup>14</sup> For example, Charles McBride, in “The Calculation of Postal Inframarginal Costs,” a study of institutional costs done for the Commission, c. October 2014, states: “The constant elasticity function plays a major role in postal costing because it is a simple one-parameter function that can reflect the economies of scale and scope inherent in many postal activities” (at 5). An analyst could be forgiven for preferring simple functions *ceteris paribus*, but McBride writes carefully for another reason. A showing that economies of scale and scope are the cause of the observed behavior is required to justify selecting a curve that can reflect them and then concluding that such economies are lost. Without such a showing, the conclusion is little more than conjecture.

It is true that volume reductions have made it appropriate for the Postal Service to realign its network, which is not a minor undertaking and which qualifies as a scale reduction for associated costs. It has also taken steps to remove costs associated with excessive postal facilities. Both of these tend mostly to come out of fixed costs.

To help identify the root causes of the cost increases, and thus to help get a handle on what is wrong, the Commission has asked for additional information, mostly disaggregate in nature, on the key postal processing functions.<sup>15</sup> The Postal Service has responded in degree. We are hopeful that further progress along these lines can be made.

What is needed, however, is more fundamental. We explained above that the mail processing cost of 5-digit automation-compatible flats, the category in Standard Flats with the largest volume, is much higher relative to Carrier Route than it should be. We also pointed to the marginal street time and marginal casing time for Standard Flats being inexplicably high. Then we explained in Section IV that we appear at the point that a stand-alone operation set up specifically to process and deliver flats could set prices equal to or below those of the Postal Service. The implication is that flats rates are too high. It is unfair to flats mailers to lock them into the Postal Service as it now exists.

We suggest consideration to the following:

1. Increased attention to a streamlined operation where mailers prepare for the processing, drop the mail at an appropriate location, and it is channeled to the carrier. The mail must be suitable for efficient handling.

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<sup>15</sup> The Commission referred to these functions, like bundle handling, piece handling, transportation, and carrier operations, as “pinch points.” See ACD, Docket No ACR2015, Chapter 6.



The Postal Service's recent increase to the 5-digit CR pallet discount is a good and important step in this direction.

2. Consider a pricing scheme where each CR bundle of one or more pieces is charged for a bundle sort to get it to the carrier, and then a piece charge for casing and delivery. It does not appear that there is a low-cost role for the FSS.

3. Or, consider a pricing scheme similar to the one in Periodicals. This would help identify mail that costs more and mail that costs less, and give mailers options. It would allow mailers to play a bigger role in improving the efficiency of the processing system. It would also be a step along paths pursued by the Commission in Chapter 6 of the FY 2015 ACD.

3. Increased recognition that the Postal Service cannot be all things to all people. It is much too complex, and it has difficulty being efficient and meeting customer needs with low-cost services.

4. Give the Postal Service increased flexibility to rationalize its operations, including closing more offices and facilities, and including further service-level changes that make sense. Three-day delivery may make sense in some places. One day a week may make sense in others. It is clear that in an environment of decreasing volumes and more delivery points, some fundamental reassessments must be made. A complete rethinking of the system and its obligations seems warranted.

## **VI. Conclusion**

FY 2016 was a stressful year. Due to changes associated with Docket No. R2015-4, a substantial portion of Carrier Route was moved to Standard Flats. The mail that moved received a larger-than-average rate increase, and adjusted their operations accordingly. See ACMA Comments, Docket No. R2017-1. New rates and classification changes were implemented on January 22, 2017. We believe the health of both Standard Flats and Carrier Route will improve. Still, more work remains to create a pro-growth policy regime for catalogs. We look forward to seeing volume growth.

Our review of the results for FY2016 show indications of significant costing difficulties. Our discussion of the stand-alone cost test shows that it would be unfair to proceed with significant rate increases for catalogs and flats generally.

Respectfully submitted,

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