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

ANNUAL COMPLIANCE REPORT, 2008	Docket No. ACR2008

REPLY COMMENTS OF THE UNITED STATES POSTAL SERVICE
(February 13, 2009)

Order No. 161 (Dec. 31, 2008) set January 30 as the date for initial comments in this docket. Eleven sets of initial comments were filed in response to Order No. 161. The Postal Service will not attempt to respond to every aspect of every comment, but instead will limit its reply comments to those aspects of the initial comments to which a response appears to be warranted.

American Postal Workers Union

APWU asserts, as it did in Docket No. ACR2007, that the Postal Service's presentation of worksharing information in the ACR impermissibly "de-links" presort First-Class Mail from Bulk Metered Mail (BMM). APWU Comments at 1-4. As before, APWU claims that the Postal Service is acting in a manner inconsistent with the Commission's decision in R2006-1. The Postal Service discussed this point in its Reply Comments in last year's ACR docket. APWU also adds a new charge that the Postal Service is violating what it terms as clear direction from the Commission in its FY 2007 ACD concerning this issue.

APWU overstates, however, the import of the Commission's discussion of this issue in the FY 2007 ACD. A review of that ACD shows that the Commission discussed, but expressly did not decide, the dispute over whether worksharing cost differences should be analyzed in an intra-product or inter-product basis. Thus, like last year, and consistent with its interpretation of the law, the Postal Service analyzes worksharing cost differences within products, and not between products, which means that the Postal Service did not examine, in USPS-FY08-3 (as in USPS-FY07-3), the relationship between BMM and presort First-Class Mail for purposes of section 3652(b).[1] However, as was also the case last year, the Postal Service also noted in its ACR that it followed Commission methodology in USPS-FY08-10 (as in USPS-FY07-10), and thus provided a cost estimate for BMM, and applied that estimate to the presort categories to calculate cost differences.

As such, APWU's claim that the Postal Service is nefariously seeking to treat its approach as a "fait accompli" rings hollow. The Postal Service has clearly specified its legal position on this issue,[2] while also providing at this time all necessary data to accommodate the contrary view. For a further discussion of this issue, see the Postal Service's response to Question 6 of Order No. 169. The Commission should expressly affirm the Postal Service's approach.

Major Mailers Association

Although MMA offers many pages of criticisms of the First-Class Mail workshare cost savings estimates presented in the FY08 ACR, in most respects, the criticisms boil down to the fact that MMA is not pleased with the results of applying the established methodologies to FY08 data. MMA recognizes the distinction between changes in input

[1] The Postal Service did provide a supplemental table in response to Order No. 169, and will provide this table in future ACRs (to the extent that the Commission continues to rely on the BMM benchmark), subject to the qualifications discussed by the Postal Service in its response.

[2] As the Commission has noted, this view is shared by several other parties. See FY 2007 ACD at 63.

data and changes in analytic principles, but wants either type of change to trigger commensurate scrutiny and review:

> Nevertheless, MMA is concerned lest the Commission's focus on changes in analytical principles not deflect its attention from the Postal Service's updates of input data that have a much more significant dollars and cents impact on the derivation of workshare cost savings. … In short, MMA is concerned that the Commission not miss the input update "forest" for the analytical principle "trees" identified in Order No. 169.

MMA Comments at 2. In the context of the ACR, however, MMA's concerns are baseless. The Postal Service's basic obligation in the ACR is to follow the established methodology. MMA is not claiming that the Postal Service failed to do so. In fact, MMA would apparently prefer the Postal Service defy the established methodology by ignoring the most recent data coming out of the data systems. Using FY08 data does not constitute, as MMA would characterize it, "the Postal Service's unilateral changes to input data" (MMA Comments at 8), but rather, in reality, is *required* in order to comply with the established methodology. A major part of each established methodology is to specify the source of the input data. Where the established methodology specifies reliance on annual data coming out of an ongoing data system, in general, the failure to update would constitute a change in analytic principle. Consequently, the foundation upon which MMA's entire comments rest is so fundamentally flawed as to render them virtually useless.

In its criticism of the Commission-approved mail flow models, MMA presents Table 8 and Table 9 and attempts to compare "modeled" costs for BMM and presort mail, versus what MMA refers to as "Actual CRA" costs for the same two categories. MMA Comments at 13-15. First, this comparison of "modeled" versus "actual CRA" costs is meaningless in the context of a hybrid cost model. The BMM cost model is not used to calculate the worksharing related savings estimates except for QBRM cost avoidance calculations. Second, the cost models consist of two spreadsheets: a mail flow spreadsheet and a cost spreadsheet. These spreadsheets are used to calculate modeled costs. A weighted model cost for all rate categories is then computed using base year mail volumes and is tied back to the CRA using adjustment factors. The CRA proportional factors are applied in the models for the following reasons:

1- Average data are used.

2- All tasks are not modeled.

3- Cost models are, by definition, a simplified representation of reality.

Third, the single piece metered letters costs by shape are used as a proxy for BMM letters, which cannot be quantified. The proxy, however, does not reflect "actual" BMM letters cost. MMA Table 8 implies the CRA provides a cost for BMM. This is incorrect. Instead, the methodology used in the FY08 ACR, as with that used in Docket Nos. R2001-1, R2005-1, and the FY07 ACR, uses the CRA cost for single piece metered letters as a proxy for BMM. Thus, the models did not lower the actual BMM costs, since the actual costs of BMM are not known. The IOCS cannot be used to isolate BMM letters mail processing unit costs. That is why the Postal Service uses CRA derived costs for all metered mail as a proxy for BMM. As a result, the modeled costs will never perfectly equal the CRA costs.

The discussion of Nonautomation MAADC (NAMMA) and MAADC costs in the MMA Comments is not accurate. MMA erroneously claims:

> According to the basic principles of worksharing and logic it should cost less to process the MAADC letter than the NAMMA letter. Indeed, the Postal Service's models have shown this to be the case, until ACR2008

> that is. Now, *for the first time ever*, the Postal Service's updated cost calculations in ACR2008 indicate just the opposite.

MMA Comments at 12 (emphasis added). MMA points to its Table 7 to show that, in the FY08 ACR, the modeled costs for MAADC of 4.79 cents exceed the modeled costs for NAMMA of 4.17 cents. Yet this is not the first time this relationship has occurred. In Docket No. R2005-1, the modeled costs for MAADC of 5.54 cents exceeded the modeled costs for NAMMA of 4.45 cents, and in Docket No. R2006-1, the modeled costs for MAADC of 4.62 cents once again exceeded the modeled costs for NAMMA of 4.17 cents

MMA also poses several questions about why this trend is happening. From a modeling perspective, the cost estimates for nonautomation MAADC and automation MAADC letters differ because the mail pieces are processed through different operations that serve different purposes in the postal mail processing network. Nonautomation MAADC pieces must be processed through the Remote Bar Code System (RBCS) so that a barcode can be applied to the mail piece. The barcode for the mail piece will either be applied directly by the Input Sub System (ISS), or an image of the mail piece will be lifted and the barcode will be applied by the Output Sub System (OSS) after the image has been processed at a Remote Encoding Center (REC). The density tables for both the outgoing ISS and outgoing OSS operations show that roughly half of the mail finalized in both operations is local mail that is sorted to the 5-digit level, such that the next processing step would be the incoming secondary operation. While some RBCS-related costs, such as those related to REC processing, were initially much higher when the system was deployed in the early 1990s, the Postal Service has implemented several programs, such as the Remote Computer Read (RCR) program, that were designed to reduce processing costs for nonbarcoded mail over time.

In contrast, automation MAADC pieces must first be processed through the outgoing secondary operation, which is used to sort the mail piece, at a minimum, to the AADC level. The density tables show that a much smaller percentage (less than 10 percent) is sorted to the 5-digit level. A high percentage of the automation MAADC mail will therefore have to be processed in one or more downstream operations before it is sorted to the 5-digit level and routed to incoming secondary operations. In summary, both rate categories are not processed through the exact same operations, so one would not expect that the cost estimates would be identical.

MMA (Comments at 15-16) again questions the established methodology of using the NAMMA letter delivery cost as a proxy for BMM, even though its attempts to raise this exact same issue in Docket No. R2006-1 and in the FY07 ACR were rejected. The established methodology is correct. First, the unit delivery costs listed under the NAMMA presort letters are used as a proxy for BMM letters, due to the fact that they exhibit similar mail piece characteristics, and the “true” cost for BMM cannot be known. Second, both BMM cost and NAMMA cost are virtually identical.

MMA, on page 17, refuses to rely on the Commission approved, cost model derived DPS percentages. Instead, MMA wants to derive its own DPS percentages by pursuing an illogical reconciliation exercise with the carrier data system. As MMA should be aware, however, the Postal Service does not collect Delivery Pont Sequencing (DPS) percentages by rate category. The DPS percentages in the cost models are the result of various inputs in the model. Therefore, MMA's delivery cost calculations are unrealistic, self-serving, and should be rejected.

Pitney Bowes

In its Comments, Pitney Bowes contends that:

> the Postal Service's letter cost models understate presort cost avoidances for automation letters by using a single adjustment factor to tie modeled costs back to actual costs reported in the Cost and Revenue Analysis (CRA).

PB Comments at 4. The claim is based on an analysis presented in the Pitney Bowes Reply Comments in Docket No. RM2009-1, which purports to show that the ratio of CRA costs to modeled costs is lower in incoming secondary operations than in other operations. The implication is that the non-incoming secondary operations' model costs are therefore understated, and hence the models understate the cost avoidances associated with higher presort levels. The Postal Service believes that the Pitney Bowes analysis does not merit a change to the accepted methodology.

The Postal Service agrees in principle that cost model results can be controlled to the CRA by means other than the traditional approach of single "proportional" and "fixed" adjustment factors. However, differences in the results from applying a single proportional factor versus multiple factors, by themselves, do not justify using multiple factors. It must also be that the disaggregated CRA costs provide a more accurate picture of actual cost differences than the cost models.

Pitney Bowes has shown that their alternative method is different than the accepted method, but has not shown that their proposal results in more accurate cost avoidances. Using multiple factors based on more detailed CRA cost estimates than used in the single-factor method raises issues of sampling variability and non-sampling errors in the detailed estimates. Since the CRA mail processing costs are based in part on In-Office Cost System (IOCS) sample data, slicing the data more thinly will certainly involve controlling costs to CRA estimates that have higher standard errors, and thus will also increase the sampling variability of the adjusted model costs. Modest increases in the sampling variability of the cost estimates may be acceptable in some cases, but clearly there are limits to the resolution of the sampling-based data and, equally clearly, controlling model results to CRA-based estimates with excessively high sampling variability would be undesirable.

Moreover, the Pitney Bowes analysis simply asserts, and does not show, that the disaggregated CRA costs provide a more reliable basis for determining cost avoidances than the cost models. While the Postal Service strongly supports the use of cost pools to help clarify mail processing cost causation, both the Postal Service and the Commission have been cognizant of limitations of the available data in developing fine operational breakouts of the sort Pitney Bowes pursues in their proposal. Moreover, there are well-known data and operational issues (for instance, time clock practices) that are well-known as limitations of developing cost data below the cost pool level. See, e.g., Docket No. R97-1, USPS-T-12 at 4; USPS-T-14 at 27. Indeed, Pitney Bowes argued in Docket No. R2006-1 that the lack of a bright line between cost pools justified expanding the set of proportional costs. Docket No. R2006-1, PB-T-3 at 21. Carrying out separate adjustments for incoming secondary and non-incoming secondary costs depends on being able to draw a clear line with reliable data. Yet the description of Pitney Bowes' method details assumptions that were apparently necessary to deal with "Other" costs that could not be identified readily as being incoming secondary or non-incoming secondary. PB Comments, Appendix 1 at ii. Fundamentally, Pitney Bowes carries out the mechanics of its adjustment without the needed assessment of whether the underlying data sources are suitable for their intended purpose. Pitney Bowes proposes to use data and methods which, while not necessarily inadmissible, have not been subject to the scrutiny required for alteration of accepted method, and the Commission therefore should retain the currently accepted method.

PostCom

Beginning at page 1 of its comments, PostCom offers a brief characterization of the Postal Service's statutory responsibilities regarding service measurement for market dominant products, as well as Commission Order No. 140, which approved the Postal Service's proposed measurement systems. Thereafter, PostCom suggests that the Commission should use the instant docket:

> to develop a deeper understanding – on the record – of the implementation status of the proposed hybrid service performance measurement system for presort First-Class Mail®, Standard Mail letters, and Standard flats which relies on (among other things) the implementation and adoption of the Intelligent Mail® barcode.

PostCom Comments at 2.

The Postal Service considers such proposal as one that seeks to expand the instant docket well beyond its intended scope. As it pertains to service performance, Docket No. ACR2008 constitutes the Commission's review of the degree to which the Postal Service met the market dominant product service standards in effect during FY 2008, as mandated by 39 U.S.C. § 3653(b)(2). In support of that review, the Postal Service has submitted appropriate data for the Commission review and interested parties are being provided an opportunity to inform the Commission's assessment of those data.

Development of the Postal Service's hybrid service performance measurement system was the focus of Docket No. PI2008-1. Under the terms of Order No. 140 issued at the conclusion of that proceeding, the Postal Service has an ongoing obligation to report to the Commission on pertinent issues. The Postal Service expects to fulfill those obligations. The Postal Service has been engaged in extensive consultations with numerous industry representatives and the Mailers Technical Advisory Committee regarding Intelligent Mail® barcode and measurement system developments. Progress reports are shared with Industry leaders to so that stakeholders are included as implementation continues. Parties interested in further information regarding implementation of the hybrid measurement system referenced by PostCom will soon have access to routine updates and progress reports on the Postal Service's Rapid Information Bulletin Board System (RIBBS) webpage.

Public Representatives

In the initial section of their comments, the Public Representatives (PR) outline the Postal Service's current financial situation largely based on Postmaster General's written and oral testimony on January 28, 2009 before the Senate Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security. The PR Comments points out that, if the current trends continue, the Postal Service runs the risk of falling out of compliance with the requirements of the PAEA. PR Comments at 3. Second, they state that "only quick and bold action to control unit variable costs will halt the Postal Service's rapid slide into insolvency." Id.

The PR Comments then provide suggestions concerning modifications of the carrier compensation arrangement, sale of most of our retail units, the privatization of retail operations (excluding, of course, the retail outlets in remote locations), and the realignment of workshare discounts as potential solutions to changing the Postal Service business model to reduce volume variable costs and to make the business model more sustainable over the long-term. Id. at 5-7. The PR Comments go on to discuss the need to publish "a sophisticated econometric forecast" to guide the public discussion of the Postal Service's future financial condition and policy options. Id. at 19.

The PR Comments also question what they perceive to be a problem designing workshare discounts. The stated concern is that management is emphasizing "marketing goals at the expense of net revenue calculations." Id. at 6. During a time of severe economic recession and very large, continuing volume reductions, it seems wholly appropriate to emphasize marketing and to be focused on customer and volume retention. Also, if an increase in prices beyond the CPI-U cap becomes necessary, the changes need to be very carefully considered in light of volume, revenue, and net revenue impacts. In this economic climate, increasing prices solely to improve *anticipated* net revenue may be unproductive if the *actual* net revenue consequences turn out to be different from what is anticipated.

Current Financial Condition

The Postal Service obviously agrees that its financial condition has deteriorated with the unprecedented loses of mail volume in FY 2008 and during the first quarter of FY 2009. These adverse and recently accelerating volume trends reflect both the state of the economy as well as the long-term changes in postal markets as First-Class Mail migrates to the internet and other electronic communications media. According to the Postmaster General's testimony, the Postal Service projects to lose 12-15 billion pieces of mail and may incur losses up to $6 billion for FY 2009.

As Postmaster General Potter has testified:

> We are doing our best to manage through the immediate crisis. We have been adapting quickly as mail volume falls, matching workhours to a declining workload, and reducing costs in every operating and administrative unit. Doing the right things today will leave us very well positioned for an eventual economic recovery. As mail volume returns, we will ramp back up only at the rate necessary to protect productivity, keeping costs down so that operating revenue goes as far as possible.

Further, the Postmaster General stated:,

> Today, however, we are still chasing volume – which is falling faster and faster, outpacing the speed at which we can adjust operations. No one knows at what point mail volume will bottom out.

The Postal Service is responding aggressively in the short-term to the economic downturn by taking the following steps to cut cost immediately:

- Eliminating $5.9 billion in cost through fiscal year 2010,
- Cutting 100 million workhours this year,
- Freezing the salaries of all Postal Service officers and executives at 2008 pay levels,
- Halting all construction of new postal facilities,
- Pursuing efforts to consolidate some excess capacity in mail processing and transportation networks while protecting service,
- Reducing employee complement through attrition and voluntary early retirement. The number of career employees at the end of the first quarter was down by 24,240 compared to the same time a year ago.

These actions are real and determined efforts to address the current economic crisis, and when achieved, will directly and positively impact the Postal Service's financial results. But if the volume decline continues to accelerate, even these actions may not be adequate to maintain 100 percent cost coverage for some of our products.

Issues Related to Volume Variable Costs

The Public Representatives place heavy emphasize on increases in variable unit cost. They note that "in the face of rapidly declining volume, variable costs per workhour, and variable costs per piece have been steadily and rapidly rising. With variable costs per piece generally rising faster than inflation, prospects are that products which are currently near the edge in terms of recovering their attributable costs are soon likely to fall into non-compliance with the fundamental objective of the PAEA that market dominant mail classes and competitive products remain in the black." PR Comments at 2-3. Even though the PR Comments seem to attribute this situation, at least in part, to declining volume, in the following paragraph, they state that "increases in volume will not, in fact, solve the problem." Id. at 3.

The PR Comments state that "only quick and bold action to control unit variable costs will halt the Postal Service's rapid decline into insolvency." Id. At best, the logic of this argument is confusing. If volume declines cause the problem, why would not volume increases improve the situation, at least to some extent? Secondly, the PR Comments fail to consider that failure to reduce institutional costs may also affect the Postal Service's solvency. Volume does matter to financial performance. The institutional cost must be covered by contribution from sales. To the extent that a product is producing contribution, additional volume will improve the overall financial results. As an example, consider a situation where product volume of 100 million pieces is producing $100 million in revenue and requires variable costs of $60 million to produce. This product example would generate $40 million of contribution to institutional costs. If volume declines to 50 million pieces, the revenue declines to $50 million, variable costs theoretically decline to $30 million over time, and the contribution produced declines to $20 million. A subsequent return of volume to the 100 million piece level would generate $20 million of additional contribution. Volume matters, but the Postal Service recognizes that efficiency also matters.

From a management viewpoint, volume variable costs, while based on actual expenditures, are the result of a set of allocation processes defined and controlled by the Postal Regulatory Commission's approved cost allocation process. They represent an economic view of how product costs **should** vary with volume, but it must be recognized that costs do not **automatically** vary with volume. Management of volume variable costs is a by-product of management efforts to balance cost drivers such as union contracts, staffing levels and utilization, personnel benefits that are controllable under the law, utilization of transportation capacity, and management of discretionary expenditures, to name a few. Significant constraints oftentimes limit the speed at which costs can be reduced. These constraints may include delays in recognizing the severity or depth of a volume decline, inability to immediately eliminate longer term variable costs such as facility and equipment costs, the provisions of union contracts, contractual minimums in transportation contracts, and process delays in reorganizing carrier routes or closing plants and other facilities. The effect of these limitations and constraints becomes more pronounced during periods of large, rapid declines in volume.

The PR Comments also suggest approaches to better manage the Postal Service's variable unit costs. The Comments propose that the carrier compensation system be realigned and that all except remote retail units be sold and retail operations privatized. Id. at 6-7. While the Comments may consider these realistic proposals, they seem to overlook the current union contracts and the negotiation process, the arbitration process, and any long-term leasing or rental commitments, along with any other processes that may impede the quick resolution of these issues.

As discussed above, the Postal Service is currently taking very aggressive actions to remove as much cost from the system as possible. But these efforts must be balanced against the requirements of various laws governing the Postal Service, service levels, and other practical realities. Postal management must react in the short term, but also must consider the impact of decisions on the longer term relationships with our customers, employee organizations, the Commission, and other stakeholders. Merely saying that the Postal Service must manage volume variable cost to improve cost coverage, greatly oversimplifies the situation that the postal management must deal with in during what may well be the most significant downturn in economic activity since the Great Depression. Management must ensure that when the economic turmoil settles, a viable and trusted Postal Service still exists.

Forecasts

As mail volume declines and mail classes face the possibility of falling into non-compliance in the near term, the Public Representatives believe that the Postal Service should be required to provide "sophisticated econometric forecasts of the Postal Service's future financial condition." Id. at 19. Supposedly, this information will allow the Commission, the PR, postal stakeholders and the public to "properly evaluate the need for such things as exigent rate cases and compliance remedies under section 3653." Id. Additionally, these forecasts could be used, supposedly, to evaluate how the current regulatory regime is working. The PR Comments suggest that these forecast should be included in the ACR or filed as a separate report and that they should be based on the forecasts that are produced for management needs.

The Postal Service stated its positions in detail concerning the filing of forecasts and monthly reports in Docket No. RM2008-4 on pages 22-30 in its Initial Comments (Oct. 16, 2008) and on pages 18-21 in its Reply Comments (Nov. 14, 2008). There is no need to repeat those positions here, but they are highly germane to the views expressed in the PR Comments on this topic.

Time Warner

The initial comments of Time Warner consist essentially of an attachment which reproduces a statement (Estimates of Worksharing Related Cost Avoidances for Periodicals Flats in ACR2008) presented at the January 26th Technical Conference by its consultant, Halstein Stralberg. Unfortunately, the postal representatives at the technical conference were not aware that the concerns raised by Mr. Stralberg's statement had previously been addressed in an earlier filing. Specifically, the Postal Service on January 21, 2009, filed a spreadsheet with its response to Question 11, Commission Information Request No. 1. With two exceptions, the cost avoidances provided in column 7 of Mr. Stralberg's Table 1, which, according to him, show "worksharing cost avoidances calculated according to the Commission's current methodology" match the cost avoidance column provided in the Postal Service's CIR

No. 1 Excel file (CIR.1.Q11.PeriodicalsDiscountTable.xls, Tab: Periodicals Outside County). The exceptions are the two numbers in the last two rows of Column 7 in Mr. Stralberg's Table, which correspond to cells F29 and F31 in the CIR 1 Excel file, column F, titled Avoided Cost. These two numbers calculate the cost avoidance due to barcoding of the mailpiece. The Postal Service believes that its calculation of these two numbers in the CIR 1 Excel file is accurate. Mr. Stralberg may have used the ADC presort level to calculate these differences rather than the MADC presort level.

<u>Valassis and SMC</u>

Delivery Costs

In its initial comments dated January 30, 2009, Valassis Direct Mail Inc and the Saturation Mailers Coalition ("Valassis") raised three issues concerning the Postal Service's derivation of FY2008 unit delivery costs. Valassis Comments at 11-15. In the 2008 Annual Compliance Report (ACR), unit delivery costs are located in USPS-FY08-19.

First, a typographical error is identified in the UDCInputs workbook, Valassis at 11. The Postal Service acknowledges this mistake and agrees with the revised unit cost of 6.378 cents for ECR High Density Flats.

Second, Valassis states that Saturation flat unit costs should include the costs of all flats, whether addressed or not. Valassis Comments at 11-12. The Postal Service concurs that the established methodology for computing unit delivery costs for ECR Saturation Flats include costs for both addressed and unaddressed pieces. However, a review of the computational algorithm used to compute unit delivery costs for ECR saturation shows that the established methodology was followed in the 2008 ACR. It is true that Worksheet Table 1 in workbook UDCModel08 contained in USPS-FY08-19 lists unit costs for ECR Saturation Flats with and without DALs. But this breakout was done solely to provide additional information beyond the overall unit costs. The additional breakout was provided because many interested parties may wish to know the impact of DALs on unit delivery costs. This does not affect the fact that the final official ECR Saturation Flat delivery cost, including the costs of DALs, is 4.623 cents in FY08.

To demonstrate that the established algorithm was used, we briefly review it here, highlighting where in the respective worksheets the calculations are made. The derivation of unit delivery costs for Saturation Flats can be divided into two parts, 1) costs for flat-shaped pieces that paid flats rates and 2) costs for letter-shaped pieces that paid flats rates (LSRAFs).

The costs for flat-shaped pieces that paid flats rates are found rows 113 through 119 in worksheet '11SummaryBY,' in workbook UDCModel08 in USPS-FY08-19. The total cost for flat shaped pieces equals the sum of costs for unaddressed flats (row 117), addressed flats (row 119), and Detached Address Labels (DALs) (row 116). These costs are totaled in row 115 and divided by RPW ECR Saturation Flats volume to produce a unit delivery cost of 4.46 cents.

The costs for LSRAFs were based upon their volume and are calculated in worksheet '1a DAdjustment,' in workbook UDCModel08, in USPS-FY08-19. The justification for this adjustment was explained in the Postal Service's response to Order No. 169 on January 21, 2009. This shifted $14.2 million in delivery costs ECR Saturation letters to flats.

Adding the $14.2 million for LSRAF to the $393.5 million for flat-shaped pieces and applying the appropriate piggyback factors results in a final unit delivery cost of 4.623 cents for ECR Saturation Flats. This value can be found in cell G80 worksheet 'Table 1', workbook UDCModel08, USPS-FY08-19. In short, the final ECR Saturation Flat unit delivery costs as displayed in USPS-FY08-19 adhere to the established methodology and include costs for unaddressed flat shaped pieces, addressed flat shaped pieces, DALs, and LSRAFs.

Third, Valassis discusses several aspects of the established methodology for distributing rural delivery costs to products in CS10.xls and proposes a change to the established methodology, Valassis at 12-15. It appears that both the discussion and the proposed change are based upon misunderstanding of how the established methodology works. The discussion and proposed change focuses on variations in rural carrier costs per RCCS piece, when in fact the established methodology is used to distribute attributable rural carrier costs to products and is embodied in attributable rural costs per RPW piece. This is an important distinction because the proposed change alters the rural carrier cost per RCSS piece but has no effect on the rural carrier cost per RPW piece. In sum, the established methodology for distributing rural delivery costs is correct and implementing the suggested change has no effect on attributable delivery costs for rural carriers.

The Rural Mail Count (RMC) is used two ways in computing attributable rural carrier costs: 1) it establishes the variable portion of rural carrier costs; and 2) divides the variable portion into compensation categories (i.e. cost pools) which are largely defined by mail types such as DPS letters, other letters, flats, parcels, boxholders (unaddressed) pieces.. This latter division, which determines the relative sizes of the rural attributable cost pools, is done through multiplying the evaluated mail counts for each compensation category by the negotiated time standard for a piece in the respective compensation categories. Once the attributable cost pools have been established, the Rural Carrier Cost System (RCCS) is used to distribute the costs within each compensation category to products.

Quite naturally, the evaluated mail counts in the Rural Mail Count will differ from the volumes in the RCCS. For example, the Rural Mail Count is a count of mail on nearly all rural routes that occurs periodically over a two- to four- week period whereas the RCCS is an ongoing system that samples rural routes every delivery day. As a result, as Valassis points out, the RMC proportions do not align with the RCCS proportions.[3] This is not a cause for concern, however. The two data systems measure different things.

Although the differences between RMC and RCCS, are to be expected, Valassis presents them as evidence that the established methodology needs to be altered so that the RCCS volume proportions across compensation categories (not products) are adjusted to match the RMC volume proportions. Valassis proposes this change despite agreeing that the RMC is the correct source to use in establishing rural carrier cost pools (because it is the basis of rural carrier compensation).

But Valassis' proposal is a difference without a distinction. Adjusting the RCCS volumes so that the implied compensation category relative proportions match the RMC evaluated mail count proportions has no impact on the rural or final attributable delivery

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[3] In fact, there are multiple causes for differences between the two systems such as: 1) seasonality of volumes and 2) changes in volume over time.

costs. This is because the proposed adjustment adjusts the RCCS volume by compensation category but does not alter the RCCS volumes by product. Recall, it is only the products' proportions that are used in distributing costs. The Valassis proposal would result in different unit costs per delivered piece for the compensation categories as shown in Table 5 on page 15, and thus a different unit cost per RCCS piece. But such costs are illustrative and do not figure in the calculation of attributable costs. The final attributable rural unit delivery costs by product (see worksheet '11SummaryBY' column R, workbook UDCModel08, USPS-FY08-19) are computed using RPW volume as the denominator, not RCCS volume.

Processing Costs

On pages 9-11, Valassis raises two points with regard to ECR Unit Costs (USPS-FY08-18). On page 10, Valassis identifies some apparent errors in the volumes and pounds data contained in spreadsheet FY08 ECR Unit Costs.xls of USPS-FY08-18. On February 9, 2009, Valassis filed the spreadsheet "Corrected_FY08 ECR Unit Costs.xls". It contains yellow highlights on cells for the last two sheets in that spreadsheet showing the volumes and pounds data which Valassis proposes should be corrected. The Postal Service has reviewed the Valassis proposals and accepts all the volume and pound input data corrections shown on these sheets with one exception. The proposed revision in cell e30 on sheet "ECR Drpshp Adj" should not be made, and that cell instead should remain as 284,590,139. Attached to these comments electronically is a spreadsheet (Reply.Valassis.Attach.FY08.18.xls) which reflects incorporation of all of the corrections which the Postal Service views as valid into the file which was originally submitted as FY08 ECR Unit Costs.xls in USPS-FY08-18. This spreadsheet has yellow highlighted cells where corrections were made.

On pages 9-10, Valassis also argues that the adjustment shifting flat-rated letter shaped costs should be done separately for high density and saturation. Such a refinement of the adjustment may have some merit as well, but the impact is not large. The file attached to this response does not reflect the Valassis proposal regarding separate adjustment factors.

Worksharing Concept

In Section III of its comments, Valassis observes that Item 9 of Order 169 appears to hold the view that cost and price differences between the density levels in the former ECR subclasses (now spread over three products) constitute differences due to worksharing. Valassis Comments at 16-18. Valassis argues that this view is not consistent with either the new product groupings, or the fact that no mailer preparation takes place to avoid work that the Postal Service might otherwise do to convert mail from a lower address density to a higher density. The Postal Service fully concurs with Valassis that address density is not worksharing, subject to the limitations of section 3622(e). The Postal Service discussed this issue in its Response to Order No. 169.

Valpak

Service Performance

Like PostCom, Valpak seizes the occasion of Docket No. ACR2008 to revisit matters that were the subject of Docket No. PI2008-1. At page 59 of its initial comments, Valpak observes that the Postal Service's FY 2008 Annual Compliance Report does not contain "any specific performance targets . . . " and argues that:

> [t]his omission makes meaningful analysis impossible. Service performance targets inform mailers realistically what to expect, they constitute a vital dimension of service quality, and they are integral to achieving accountability within the performance measurement scheme incorporated in the PAEA.

Valpak Comments at 59-60. The Postal Service agrees that numerical operational performance targets can serve as a useful benchmark against which service quality can be judged. However, reliance on such targets is not prescribed as the only permissible approach by the Postal Accountability and Enhancement Act. Service performance can be judged against applicable service standards as well as by reference to performance goals established in relation to those standards.[4] Accordingly, the Postal Service does not agree with Valpak's assertion that service performance analysis is meaningless without operational performance targets.

Valpak's sniping about the absence of FY 2008 numerical targets fails to acknowledge that any set of fiscal year operational targets must have, as its foundation, an established set of service standards and some degree of clarity regarding the mail processing and transportation networks that will be in place to support pursuit of applicable standards and targets. As FY 2008 began in October 2007, the Postal Service was still nearly three months away from developing the modern service standards mandated by 39 U.S.C. §3691(a), and nearly nine months away from finalizing the network plan that would provide a foundation for achieving them. Hindsight now informs the Postal Service that it could have avoided Valpak's criticism

[4] The Postal Service fulfilled the statutory mandate in 39 U.S.C. § 3691(a) to modernize it market dominant product service standards on December 19, 2007. See 72 *Fed Reg* 72216. The Postal Service satisfied the related requirement in uncodified PAEA section 302(b)(1) to establish performance goals related to its modern service standards when it submitted its network plan to Congress. See USPS PAEA § 302 Network Plan at 7 (June 19, 2008).

had it simply put the cart before the horse in September 2007, and established FY 2008 performance targets based upon service standards that had yet to be modernized and a network vision that had yet to be settled upon.

Service standards represent the goals for service achievement for a mail product or class. Service measurement systems generate data indicating the degree to which such standards are actually achieved. Performance targets are operational goals established by the Board of Governors for postal management to pursue.[5] Although the Postal Service disputes the assertion by Valpak that numerical operational performance targets are mandated by the PAEA as the benchmark for analyzing service performance, the Postal Service agrees that they can serve as relevant criteria for evaluating the quality of service. The USPS Board of Governors has established such operational targets as part of the basis for evaluating FY 2009 postal management performance. These FY 2009 targets are published at www.ribbs.usps.gov, under the site index topic "Targets." The Postal Service concurs with Valpak that publication of these targets will increase transparency and accountability and that they also can provide part of the basis upon which to evaluate FY 2009 service performance.

However, the Postal Service rejects the overreaching assertion of Valpak that:

> any reduction in, or degradation of, service performance targets would correlate with a nationwide decline in service quality . . . [and] would need to be subject to Commission review.

[5] Thus, the service standard for a product may be the provision of service within two delivery days after mail acceptance. Measurement system data may show that this standard is met 94 percent of the time. The operational target set by the Board of Governors for this product may be 95 percent on-time service. The Postal Service is of the view that customer expectations are based much more upon the degree to which the applicable service standard is met than the degree to which the operational goals of the Board are met.

Valpak Initial Comments at 60, n.69. Assume, hypothetically, that the USPS Board of Governors decide that the operational goal or target for the achievement of on-time delivery of overnight First-Class Mail should be adjusted from 96 percent -- either upward to 97 percent or downward to 95 percent. Assume, in that same scenario, that actual service performance, as objectively measured, remains absolutely constant from year to year, irrespective of whether the on-time target is 95, 96 or 97 percent. Changing the performance target may mean that, correspondingly fewer or more postal managers meet the operational goal *de jour*. However, it does not necessarily follow that the service actually provided to customers is either upgraded or degraded, as Valpak suggests.

Even if one agrees that changes in performance targets are relevant to the Commission's 39 U.S.C. § 3653 annual compliance review, it does not follow that performance target changes are subject to Commission review under section 3661. A decision to change performance target is qualitatively different from a decision, for instance, that overnight First-Class Mail service standards be changed to either same-day or two-day service standards. The former involves a change in the operational target by which postal management will be judged to have performed. In contrast, the latter involves a change in the nature of the terms and conditions of the service being provided to customers.[6]

[6] In the same vein, the financial budget approved by the Board establishes spending targets for postal management. It may be true that postal operational and budgetary goals can have an impact on the quality of service provided to customers or can affect the nature of the terms and conditions of products and services that the Postal Service decides to offer. Taken to its logical conclusion, Valpak's argument implies that a change in postal operational or budgetary goals, *per se*, even in the absence of a

At page 61 of its comments, Valpak laments the absence of "tail of the mail" data in the FY 2008 ACR Report that might more fully inform the Commission on the subjects of consistency and reliability of service. Contrary to the assertion at page 62 of Valpak's comments, the Postal Service has no "misgivings" about the production or publication of such data. Valpak must surely concede that the reporting of useful and informative data requires that measurement systems be sufficiently well-developed and robust to depict the service actually provided for various products. The development of the service performance measurement systems approved in Order No. 140 involved extensive consultations with the mailers and the Commission that were extremely constructive, but more protracted than would permit the production of robust data in time for the FY 2008 ACR. As reflected at www.usps.com/serviceperformance sufficient progress was made during FY 2008 to permit the generation of very limited "tail-of-the-mail" data for quarter 1 of FY 2009.[7] As more mailers embrace the Intelligent Mail® Full Service option and more robust and representative data are generated, Valpak's patience will be rewarded.

At page 63 of its comments, Valpak expresses disappointment that the Postal Service's provision of FY 2008 Package Services service performance data was not

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change in the terms of and conditions of product offering, are subject to review under 39 U.S.C. § 3661. The Postal Service rejects this argument.

[7] That same FY 2009 Q1 report reflects product-specific service performance data that permit an assessment of the timeliness with which Delivery Confirmation information is provided to the sender in relation to the applicable 24-hour standard. At pages 62-63, Valpak expresses concern about the availability of such data for future Annual Compliance Reports. Valpak can be assured that such data will be reflected in the FY 2009 ACR. The FY 2009 Q2 data, which also will be posted at www.usps.com. are expected to reflect the first iteration of data intended to represent the percentage of Delivery Confirmation purchases for which there is no recorded stop-the-clock scan. This would appear to be the first step in addressing the concerns expressed at pages 62-63 of Valpak's comments.

accompanied by a narrative discussion, a comparison to the previous year's figure, or reference to a FY 2008 performance target.[8]

Current service performance for Package Services can best be understood by reference to the USPS PAEA § 302 Network Plan, which summarizes the state of the postal Bulk Mail Center network and the need to transform it:

> The Postal Service currently operates a national network of 21 BMCs. These facilities primarily support the distribution and transportation of Standard Mail, Periodicals, and Package Services. The BMCs were built and began operations in the 1970's. BMCs process container handlings, not single-piece sortation. Mail is processed through manual and mechanized operations, and then loaded onto trailers for surface transportation. Originally, because nearly all customer mail volume was entered at origin locations, BMC facility and transportation utilization was very efficient.
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> With the introduction of mail preparation and transportation discounts, mailers began bypassing origin BMCs, presorting mail and entering it downstream at destination postal facilities. That trend has accelerated over the last several years. In FY 2007, 52 percent of Parcel Post was dropped at delivery units and 45 percent of Standard Mail was dropped at destination mail processing plants, thus bypassing BMC processing completely. Consequently, BMCs have excess distribution capacity. Some have reduced operations from 24 to 16 hours a day, and have closed some weekend operations.
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> BMC facilities are strategically situated near major metropolitan areas and transportation centers. Therefore, they are valuable assets that provide excellent logistical reach for various mail product lines. However, because of increased mailer sortation and downstream drop shipments, these postal assets are currently underutilized. This factor, in combination with increased highway contract expenses and an aging postal distribution infrastructure, has prompted an intense evaluation of the BMC network to determine how it can best support future postal operations.

USPS PAEA § 302 Network Plan at 30. The state of the BMC network is a matter of public record. Until the Postal Service makes the transformative operational and

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[8] The absence of FY 2008 performance targets was discussed above and will not be repeated here.

transportation changes necessary to improve the quality of service, on-time delivery performance will lag behind the level of service provided to products that do not rely so heavily on the BMC network.

Otherwise, Valpak raises issues regarding the format in which data service performance data should be reported. The Postal Service will continue to cooperate in the production of service performance reports that meet the requirements of 39 U.S.C §§ 3652 and 3653. At page 7 of Order No. 140, the Commission indicated its intent to initiate a notice-and-comment rulemaking to address issues relating to the content and format of periodic reports generated by the Postal Service's performance measurement systems. The Postal Service believes that the proper forum for a discussion of such issues would be in that rulemaking and looks forward to the opportunity to participate.

Cost Coverages

Valpak expresses its view that the cost coverages for Standard Mail High Density/Saturation Letters, High Density/Saturation Flats, and Regular Letters are too high, and that this raises, at least for Regular Letters, "compliance questions." Valpak Comments at 52. It bases this position on the view that the costs coverages for these products, relative to the cost coverages for other products, are not consistent "with guidance provided in the PAEA." Id. at 44. In particular, Valpak seems to believe that the PAEA requires that paramount consideration be given to cost coverages, and elasticities, in designing prices. However, Valpak's Comments evince no recognition that the PAEA was intended, as the Commission has previously noted, to give the Postal Service considerable flexibility in setting prices (subject to some specific standards, such as with respect to the price cap, and the setting of workshare discounts). As the Postal Service has stated many times in the past, it takes many factors into account when pricing; cost coverage is but one consideration.

Valpak's view that the cost coverages for the High Density/Saturation products, and for Regular Letters, raises compliance concerns harkens back to the pre-PAEA regulatory structure, in which the Commission, for all practical purposes, established the prices. Under the new structure, the Postal Service is afforded much more flexibility, and the policy directives in the PAEA are not as explicit or restrictive. Certainly, under the legal standards set forth in the PAEA, the cost coverages for these three products during FY 2008 do not justify any determination that the Postal Service was out of compliance with any provision of chapter 36 during that fiscal year.

Furthermore, Valpak argues that because the cost coverage of Standard Mail Flats was below 100 percent in FY 2008, that product is "substantially out of compliance with the PAEA," at least in the absence of a high elasticity. Id. at 52. Yet, Valpak recognizes elsewhere in its Comments that the standards of section 3622 only "require" that a market-dominant *class* cover its costs. Id. at 12-14. Of course, the Postal Service is not claiming that it is sound to have a market-dominant product that fails to cover its costs, particularly over the long-term. See, e.g., ACR at 23. However, it is clear from the statute that the failure of a market-dominant product to cover its costs in a particular year is not assessed under the same standard as competitive products in section 3633(a)(2). In other words, the failure of a market-dominant product to cover its costs in one year should not, in and of itself, lead to a "non-compliance" determination under section 3653.

Valpak's comments also raise the issue of how the nonprofit / commercial unit revenue ratio of section 3626(a)(6) is calculated. Valpak Comments at 55-58. While Valpak is careful to point out that it is not taking a position on this issue, it does "recalculate" nonprofit / commercial ratios at the product level, as opposed to the class level. Valpak's reason for doing so is to make the narrow point that a product-level application of section 3626(a)(6) would increase the calculated cost coverage for the High/Density and Saturation products.

The proper calculation of this ratio was first addressed in Docket No. R2008-1. In that case, the Postal Service expressed its view that the appropriate successor to the "subclasses" mentioned in the statute should be the Standard Mail class as a whole. The Commission accepted this interpretation as being consistent with the law, both in its review of the Postal Services' new prices, and later in the FY 2007 ACD. See Order No. 66 at 32; FY 2007 Annual Compliance Determination at 87-88.

Valpak's discussion of this issue, simply to make its narrow point concerning the cost coverage for the products it is interested in, should not entice the Commission to reconsider its acceptance of the class-level approach. A review of section 3626(a)(6) shows that it was not updated when the PAEA was passed: it not only uses the term "subclasses," which has been replaced in the new regulatory structure with the "products," but also refers to the "factors" of section 3622(b), whereas that section lays out "objectives" (the "factors" are set forth in section 3622(c)). Thus, the question becomes how to apply this language to the new pricing structure, in a way that best effectuates the purposes of that provision, in light of the new regulatory principles.

While calculating the ratio at the product level may help Valpak to make its point, it could constitute bad business policy in the long run.

For instance, whereas the creation of new subclasses was a rare event during the PRA regime, encompassing as they did relatively large groupings of mail, the creation of new products may be less rare. For example, new Standard Mail products may be added, in order to recognize important market segments, such as through niche classifications. Applying the ratio to smaller and smaller groupings of mail would rob the Postal Service of needed pricing flexibility and potentially lead to highly undesirable outcomes. Consider a niche product that consists of a group of mail with a low cost coverage (though not necessarily a low unit contribution). In such a circumstance, section 3626(a)(6), if applied at the product level, could require the Postal Service to set nonprofit prices at economically unwise levels. This situation could also occur within the context of the current product makeup of Standard Mail. For instance, the FY 2008 ACR shows that the Parcels / NFMs product currently does not cover its costs. Were subsequent price increases to raise this cost coverage to, say, 125 percent, interpreting section 3626(a)(6) as requiring that nonprofit Parcels / NFMs have an average revenue that could not exceed 60 percent of commercial Parcels / NFMs would almost certainly guarantee that most, if not all, nonprofit Parcels / NFMs would fail to cover their costs, which is not consistent with the Postal Service's business interest in having its costs covered. Clearly, it is superior to interpret section 3626(a)(6) in a way that precludes such an outcome, by applying it at the class level, when such an interpretation fully achieves the purposes of that provision.

Moreover, Valpak's apparent reason for raising this issue—to point out that the lower nonprofit / commercial ratio for the High Density and Saturation products "understates" the coverage on the commercial saturation mail—is largely beside the point. As discussed above, cost coverages are simply one factor taken into account in pricing. Hence, arguments that the cost coverage for these products would be higher using method A, rather than method B, or under assumptions C, rather than under assumptions D, does not change the fact that the Postal Service considers a host of relevant factors when developing prices for High Density and Saturation mail. The relative size of cost coverages is not the decisive factor. And, more particularly, the fact that the cost coverages for these products might be slightly higher under a different method does not indicate that the Postal Service has not "complied" with chapter 36 during FY 2008.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document in accordance with Section 12 of the Rules of Practice and Procedure.

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