AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

THE PRICE IS RIGHT, OR IS IT? AN EXAMINATION OF USPS WORKSHARE DISCOUNTS AND PRODUCTS THAT DO NOT COVER THEIR COSTS

HEARING

BEFORE THE

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

MAY 12, 2010

Serial No. 111–76

Printed for the use of the Committee on Oversight and Government Reform

Available via the World Wide Web: http://www.gpoaccess.gov/congress/index.html
http://www.house.gov/reform

U.S. GOVERNMENT PRINTING OFFICE

58–349 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

EDOLPHUS TOWNS, New York, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
CAROLYN B. MALONEY, New York
ELIJAH E. CUMMINGS, Maryland
DENNIS J. KUCINICH, Ohio
JOHN F. TIERNEY, Massachusetts
WM. LACY CLAY, Missouri
DIANE E. WATSON, California
STEPHEN F. LYNCH, Massachusetts
JIM COOPER, Tennessee
GERALD E. CONNOLLY, Virginia
MIKE QUIGLEY, Illinois
MARCY KAPTUR, Ohio
ELEANOR HOLMES NORTON, District of Columbia
PATRICK J. KENNEDY, Rhode Island
DANNY K. DAVIS, Illinois
CHRIS VAN HOLLEN, Maryland
HENRY CUELLAR, Texas
PAUL W. HODES, New Hampshire
CHRISTOPHER S. MURPHY, Connecticut
PETER WELCH, Vermont
BILL FOSTER, Illinois
JACKIE SPEIER, California
STEVE DRIEHAUS, Ohio
JUDY CHU, California

DARRELL E. ISSA, California
DAN BURTON, Indiana
JOHN L. MICA, Florida
MARK E. SOUDER, Indiana
JOHN J. DUNCAN, JR., Tennessee
MICHAEL R. TURNER, Ohio
LYNN A. WESTMORELAND, Georgia
PATRICK T. MCHENRY, North Carolina
BRIAN P. BILBRAY, California
JIM JORDAN, Ohio
JEFF FLAKE, Arizona
JEFF FORTENBERRY, Nebraska
JASON CHAFFETZ, Utah
AARON SCHOCK, Illinois
BLAINE LUETKEMEYER, Missouri
ANH "JOSEPH" CAO, Louisiana

RON STROMAN, *Staff Director*
MICHAEL MCCARTHY, *Deputy Staff Director*
CARLA HULTBERG, *Chief Clerk*
LARRY BRADY, *Minority Staff Director*

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA

STEPHEN F. LYNCH, Massachusetts, *Chairman*

ELEANOR HOLMES NORTON, District of Columbia
DANNY K. DAVIS, Illinois
ELIJAH E. CUMMINGS, Maryland
DENNIS J. KUCINICH, Ohio
WM. LACY CLAY, Missouri
GERALD E. CONNOLLY, Virginia

JASON CHAFFETZ, Utah
MARK E. SOUDER, Indiana
BRIAN P. BILBRAY, California
ANH "JOSEPH" CAO, Louisiana

WILLIAM MILES, *Staff Director*

CONTENTS

	Page
Hearing held on May 12, 2010	1
Statement of:	
Burrus, William, president, American Postal Workers Union, AFL–CIO; Lawrence G. Buc, president, SLS Consulting, Inc.; Michael Riley, professor, University of Maryland University College; James R. O'Brien, vice president for distribution and postal affairs, Time Inc.; and Hamilton Davison, executive director, American Catalog Mailers Association	47
Buc, Lawrence G.	70
Burrus, William	47
Davison, Hamilton	100
O'Brien, James R.	92
Riley, Michael	82
Robinson, Maura, vice president of pricing, U.S. Postal Service; and John Waller, director of Office of Accountability and Compliance, Postal Regulatory Commission	10
Robinson, Maura	10
Waller, John	20
Letters, statements, etc., submitted for the record by:	
Buc, Lawrence G., president, SLS Consulting, Inc., prepared statement of	72
Burrus, William, president, American Postal Workers Union, AFL–CIO, prepared statement of	50
Connolly, Hon. Gerald E., a Representative in Congress from the State of Virginia, prepared statement of	9
Davison, Hamilton, executive director, American Catalog Mailers Association, prepared statement of	102
Kucinich, Hon. Dennis J., a Representative in Congress from the State of Ohio, prepared statement of	118
Lynch, Hon. Stephen F., a Representative in Congress from the State of Massachusetts:	
Prepared statement of	4
Prepared statement of the National Newspaper Association	32
O'Brien, James R., vice president for distribution and postal affairs, Time Inc., prepared statement of	94
Riley, Michael, professor, University of Maryland University College, prepared statement of	84
Robinson, Maura, vice president of pricing, U.S. Postal Service, prepared statement of	13
Waller, John, director of Office of Accountability and Compliance, Postal Regulatory Commission, prepared statement of	22

THE PRICE IS RIGHT, OR IS IT? AN EXAMINATION OF USPS WORKSHARE DISCOUNTS AND PRODUCTS THAT DO NOT COVER THEIR COSTS

WEDNESDAY, MAY 12, 2010

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 3:01 p.m., in room 2154, Rayburn House Office Building, Hon. Stephen F. Lynch (chairman of the subcommittee) presiding.

Present: Representatives Lynch, Norton, Cummings, Kucinich, Clay, Connolly, Chaffetz, and Bilbray.

Staff present: Jill Crissman, professional staff; Aisha Elkheshin, clerk/legislative assistant; Williams Miles, staff director; Rob Sidman, detailee; Dan Zeidman, deputy clerk/legislative assistant; Howie Denis, minority senior Counsel; and Alex Cooper, minority professional staff member.

Mr. LYNCH. Good afternoon. The subcommittee on Federal Workforce, Postal Service, and the District of Columbia hearing will now come to order. I apologize for the brief delay. We had some roll calls on the floor. But I would like to welcome our ranking member, Mr. Chaffetz, and members of the subcommittee, all hearing witnesses and those in attendance.

In light of the financial difficulties confronting the Postal Service, we have called today's hearing to explore the current economic impact on various workshare discounts, and to examine whether these pricing structures correctly incentivize mailers. The hearing will also investigate the issues related to products that do not currently cover their costs. The chair, the ranking member, and the subcommittee members will each have 5 minutes to make opening statements, and all Members will have 3 days to submit statements for the record.

Again, welcome.

As you are undoubtedly aware, the Postal Service continues to confront a dire financial situation. While the Postal Service has recently revealed some good news, that it is doing better than previously anticipated by some $1.2 billion, the organization is still on track to lose approximately $7 billion by the end of this year. And this will be on top of a cumulative loss of nearly $12 billion over the previous 3 fiscal years.

Much of the Postal Service's recent financial difficulties can be attributed to the rise of electronic communication and the corresponding dramatic decline in mail volume, as well as the nationwide economic downturn, and in some ways statutorily imposed prefunding of future retiree health benefit obligations.

One of the most important tools that the Postal Service currently has to deal with its financial difficulties is its enhanced pricing flexibility as provided by the Postal Accountability and Enhancement Act. However, utilization of this flexibility has not been an easy matter, as the Postal Service and others have noted. In the given market environment, increasing rates must be justified, balanced and reasonable, since such changes could further accelerate the pace of mail volume declines.

Recent reports and studies have identified several pricing areas that should be revisited and further explored as opportunities to generate more revenue. Today this subcommittee convenes to discuss pricing issues relating to workshare discounts and products that are currently considered as not covering their costs. First, with respect to workshare discounts, the Postal Regulatory Commission's fiscal year 2009 ACD, their Annual Compliance Determination, found that 30 workshare discounts exceeded their associated costs. According to the PRC, 17 of these discounts were justified, while the remaining 13 were not properly justified and should be realigned at the next general price adjustment. Toward that end, I look forward to hearing from today's witnesses on these particular discounts and other workshare-related topics, especially given that approximately 80 percent of all USPS mail is now workshared. With such a large portion of mail being workshared, it is crucial that workshare discounts be priced to maximize revenue and efficiency of the entire postal industry, especially during such bleak financial times.

In addition to discussing aspects of worksharing, which is the amount of prep that is being done by mailers in advance of handing the mail off to the post office, and also workshare-related discounts, today's hearing also touches on the subject of postal products deemed not to cover their actual costs. Highlighted by both the PRC's Annual Compliance Determination and the Government Accountability Office's April 12th report, the Postal Service lost, in the aggregate, approximately $1.7 billion in fiscal year 2009 due to some 14 postal products that are not covering their costs of delivery. Although some of these products might be appropriately priced below cost for public policy reasons, many stakeholders have begun to call for more accurate pricing of these mailings, especially given the current financial status of the Postal Service. Toward that end, the subcommittee looks forward to an informative discussion exploring the Postal Service's pricing policies, approaches to data collection and utilization as it relates to products that have been found to fall short in covering their actual costs.

Today's hearing will provide us an opportunity to hear from the Postal Service, the Postal Regulatory Commission, our mailers, affected unions, and well-respected economists and scholars on these vital topics. It is my hope that the testimony and feedback we receive from today's witnesses will provide the committee with information on the value of these important programs in a post-Postal

Accountability and Enhancement Act environment that incentivizes the Postal Service to make a profit and to alter its business model in order to meet the current and future challenges.

Again, I thank you each of you for being with us this afternoon, and I look forward to your participation.

[The prepared statement of Hon. Stephen F. Lynch follows:]

EDOLPHUS TOWNS, NEW YORK,
CHAIRMAN

PAUL E. KANJORSKI, PENNSYLVANIA
CAROLYN B. MALONEY, NEW YORK
ELIJAH E. CUMMINGS, MARYLAND
DENNIS J. KUCINICH, OHIO
JOHN F. TIERNEY, MASSACHUSETTS
WM. LACY CLAY, MISSOURI
DIANE E. WATSON, CALIFORNIA
STEPHEN F. LYNCH, MASSACHUSETTS
JIM COOPER, TENNESSEE
GERALD E. CONNOLLY, VIRGINIA
MIKE QUIGLEY, ILLINOIS
MARCY KAPTUR, OHIO
ELEANOR HOLMES NORTON,
DISTRICT OF COLUMBIA
PATRICK J. KENNEDY, RHODE ISLAND
DANNY K. DAVIS, ILLINOIS
CHRIS VAN HOLLEN, MARYLAND
HENRY CUELLAR, TEXAS
PAUL W. HODES, NEW HAMPSHIRE
CHRISTOPHER S. MURPHY, CONNECTICUT
PETER WELCH, VERMONT
BILL FOSTER, ILLINOIS
JACKIE SPEIER, CALIFORNIA
STEVE DRIEHAUS, OHIO
JUDY CHU, CALIFORNIA

ONE HUNDRED ELEVENTH CONGRESS

Congress of the United States
House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

2157 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515–6143

MAJORITY (202) 225-5051
FACSIMILE (202) 225-4784
MINORITY (202) 225-5074

www.oversight.house.gov

DARRELL E. ISSA, CALIFORNIA,
RANKING MINORITY MEMBER

DAN BURTON, INDIANA
JOHN L. MICA, FLORIDA
MARK E. SOUDER, INDIANA
JOHN J. DUNCAN, JR., TENNESSEE
MICHAEL R. TURNER, OHIO
LYNN A. WESTMORELAND, GEORGIA
PATRICK T. MCHENRY, NORTH CAROLINA
BRIAN P. BILBRAY, CALIFORNIA
JIM JORDAN, OHIO
JEFF FLAKE, ARIZONA
JEFF FORTENBERRY, NEBRASKA
JASON CHAFFETZ, UTAH
AARON SCHOCK, ILLINOIS
BLAINE LUETKEMEYER, MISSOURI
ANH "JOSEPH" CAO, LOUISIANA

STATEMENT OF CHAIRMAN STEPHEN F. LYNCH

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA HEARING ON

"The Price is Right, or Is It? An Examination of USPS Workshare Discounts and Products that Do Not Cover Their Costs"

Wednesday, May 12, 2010, 200 p.m.
2154 Rayburn House Office Building

Ladies and Gentlemen, as you are undoubtedly aware, the Postal Service continues to confront a dire financial situation. While the Postal Service has recently revealed some good news – that it is doing better than previously anticipated by some $1.2 billion – the organization is still on track to lose approximately $7 billion by the end of this year. And this will be on top of a cumulative loss of nearly $12 billion over the previous three fiscal years. Much of the Postal Service's recent financial difficulties can be attributed to rise of electronic communications and the corresponding dramatic declines in mail volume, as well as the nationwide economic downturn, and in some ways, statutorily imposed prefunding of future retiree health benefit obligations. One of the most important tools that the Postal Service currently has to deal with its financial difficulties is its enhanced pricing flexibility, as provided by the Postal Accountability and Enhancement Act. However, utilization of this flexibility is not an easy matter, as the Postal Service and others have noted. In the given market environment, increasing rates must be justified, balanced and reasonable since such changes could further accelerate the pace of mail volume declines.

Recent reports and studies have identified several pricing areas that should be revisited and further explored as opportunities to generate more revenue. Today the Subcommittee convenes to discuss pricing issues relating workshare discounts and products that are currently considered not covering their costs. First, with respect to workshare discounts, the Postal Regulatory Commission's Fiscal Year 2009 Annual Compliance Determination found that 30 workshare discounts exceeded their avoided costs. According to the PRC, 17 of these discounts were justified, while the remaining 13 were not properly justified and should be realigned at the next general price adjustment. Toward that end, I look forward to hearing from today's witnesses on these particular discounts and other workshare related topics especially given that approximately 80% of all USPS' mail is now workshared. With such a large portion of mail being workshared, it is crucial that workshare discounts be priced to maximize revenue and efficiency of the entire postal industry, especially during such bleak financial times.

In addition to discussing aspects of worksharing and workshare discounts, today's hearing also touches on the subject of postal products deemed not to cover their costs. Highlighted by both the PRC's Annual Compliance Determination and the Government Accountability Office's April 12 report, the Postal Service lost, in the aggregate, $1.7 billion in FY 2009 due to some 14 postal products not covering their costs. Although some of these products might be appropriately priced below cost for public policy reasons, many stakeholders have begun to call for more accurate pricing of these mailings, especially given the current financial status of the Postal Service. Toward that end, the Subcommittee looks forward to an informative discussion exploring the Postal Service's pricing policies, approaches to data collection and utilization as it relates to products that have been found to fall short in covering their costs.

Today's hearing will provide us with an opportunity to hear from the Postal Service, the Postal Regulatory Commission, mailers, effected unions, and well-respected economists and scholars on these vital topics. It is my hope that the testimony and feedback we receive from today's witnesses will provide the Subcommittee with information on the value of these important programs in a post-PAEA environment that incentivizes the Postal Service to make a profit and to alter its business model in order to meet current and future challenges.

Again, I thank each of you for being with us this afternoon, and I look forward to your participation.

###

Mr. LYNCH. I now yield 5 minutes to the ranking member, Mr. Chaffetz, for an opening statement.

Mr. CHAFFETZ. Thank you, Mr. Chairman. I appreciate holding the hearing, and to all the witnesses who are here today, I appreciate your patience in waiting for us after roll call votes, and I appreciate your testimony here today and taking the time and preparation for it.

It's my understanding that the U.S. Postal Service is expecting to file an exigency rate case in July, and so this hearing's timing is significant.

The world of worksharing discounts provided to businesses which perform duties that the Postal Service would have to otherwise perform and cost attribution of postal products is extremely challenging. On a basic level it is understood that worksharing discounts should only be as big as cost savings provided, and that the postal products should be covering their attributable costs. It is also equally understood, however, that the methodology for determining attributable costs is far from an exact science. Many of these money-losing products are not stand-alone pieces of mail, but are, in fact, responsible for a great deal of additional postal communication and consequently revenue. This is the danger of taking certain products in isolation.

We must also bear in mind that products are only worth what the market is willing to pay. One cannot make the assumption that volume will stay the same as the price of the product is increased. This price sensitivity is something that we need to dive deeper into and must be studied very carefully. Hopefully this will be done leading up to the review of the rate case.

Additionally, discussions of attributable costs are incomplete without a few facts regarding institutional costs, which are paramount in this case. Obviously, in every finance class there usually is spent time addressing the potential dangers of eliminating programs, outlets, or products that are not profitable. When these programs or products are discontinued, the institutional or fixed costs that were originally allocated to the shut-down program get redistributed to the remaining products, which makes products that were previously barely profitable suddenly notprofitable. I hope that the agencies understand this. This does not mean unprofitable programs can't be shut down, but it means you have to understand the total financial implication and not just the cost savings in that bubble.

It also means that the U.S. Postal Service itself in this case must analyze its own efficiencies. While the U.S. Postal Service may be the most efficient postal system in the world, the truth is that there's no postal system like this anywhere in the world.

This hearing could help establish some very basic building blocks for knowledge on these extraordinary complex issues. I would caution against jumping to conclusions over what we hear today. The world of rate setting and adjusting has massive implications for the trillion-dollar mailing and paper industries, and any congressional intervention must be done with great caution.

With that, we look forward to this hearing, and, again, I appreciate the witnesses for their time and preparation today.

With that, Mr. Chairman, I yield back.

Mr. LYNCH. I thank the gentleman.

The Chair now recognizes the gentleman from Virginia, Mr. Connolly, for 5 minutes for an opening statement.

Mr. CONNOLLY. Thank you, Mr. Chairman. And thank you for your leadership in helping us to restructure the Postal Service and for conducting a thorough investigation of options for cost savings and revenue enhancement.

This hearing will examine workshare discounts and posted pricing for certain products that do not cover the cost of delivery. The Postal Regulatory Commission has investigated the Postal Service's workshare program and found that 30 workshare discounts are actually costing as much as they save, meaning that the Postal Service could be reducing losses by adjusting those discounts. This represents an opportunity to achieve cost savings without service cuts.

PRC also identified 61 workshare discounts that are profitable for the Postal Service. In other words, the discounts for these workshares are less expensive than the cost the Postal Service would otherwise incur by processing the mail itself.

Though some have condemned the practice as well as the underlying statute that permits the Postal Service to earn profits on these workshares, it seems to me we ought not to necessarily be discouraging the Postal Service from seeking more opportunities like these to make a profit when it's losing so much money. There is no inherent virtue in creating a workshare discount that precisely matches the cost of the Postal Service processing the mail itself. In fact, it's conceivable that the Postal Service could earn a profit through less discounted workshares by setting a price that still saves cost for private sector partners participating in workshare.

We should protect the Postal Service's ability to make profits on workshares, while supporting the PRC's oversight to ensure that the Postal Service is not losing money on workshares. Although the workshare program was intended to be temporary, if the Postal Service can use it to achieve efficiencies, it should not be curtailed or eliminated at this time.

Pricing for periodicals and mail flats represent another opportunity to increase Postal Service revenue. In 2006, Congress imposed a price cap on all classes of mail, which is linked to the Consumer Price Index. We should consider revisiting that cap to allow the Postal Service to reduce losses associated with mailing magazines and mail flats on catalogs. With these two product categories alone losing over $1.2 billion in fiscal year 2009, we need to provide authority to adjust prices as part of a broader Postal Service restructure. It's unrealistic to expect the Postal Service to function like a business when Congress has imposed pricing restrictions that do not apply to private sector businesses and competition.

Again, I want to thank you, Chairman Lynch, for your ongoing leadership to identify policy options for Postal Service restructuring. Based on today's hearing, I believe it's clear that the Postal Service should maintain its authority to make profits for workshares and to receive additional authority to adjust certain mail prices to avert losses for magazines and mail flats. And I look forward to the testimony.

Mr. LYNCH. I thank the gentleman.

[The prepared statement of Hon. Gerald E. Connolly follows:]

Opening Statement of Congressman Gerald E. Connolly

"The Price is Right, or is it?"

Subcommittee on Federal Workforce, Postal Service, and the District of Columbia

May 12th, 2010

Thanks you Chairman Lynch for your leadership on restructuring the Postal Service and for conducting a thorough investigation of options for cost savings and revenue enhancement. This hearing will examine work share discounts and postage pricing for certain products that does not cover cost of delivery.

The Postal Regulatory Commission (PRC) has investigated the Postal Service's work share program and found that 30 work share discounts are actually costing as much as they save, meaning that the Postal Service could be reducing losses by adjusting the work share discounts. This represents an opportunity to achieve cost savings without service cuts. The PRC also identified 61 work share discounts that are profitable for the Postal Service. In other words, the discounts for these work shares are less expensive than the cost that the Postal Service would incur by processing the mail itself. Though some have condemned this practice, as well as the underlying statute that permits the Postal Service to earn profits on these work shares, we should be encouraging the Postal Service to seek more opportunities like these to make a profit. There is no inherent virtue in creating a work share discount that precisely matches the cost of the Postal Service processing the mail itself. In fact, it is conceivable that the Postal Service could earn a profit through less discounted work shares by setting a price that still saves costs for private sector partners participating in a work share. We should protect the Postal Service's ability to make profits on work shares while supporting the PRC's oversight to ensure that the Postal Service is not losing money on work shares. Although the work share program was intended to be temporary, if the Postal Service can use it to achieve efficiencies it should not necessarily be curtailed or eliminated.

Pricing for periodicals and mail flats represents another opportunity to increase Postal Service revenue. In 2006, Congress imposed a price cap on all classes of mail, which is linked to the Consumer Price Index. We should consider abolishing that cap to allow the Postal Service to reduce losses associated with mailing magazines and mail flats like catalogs. With these two product categories alone losing over $1.2 billion in FY 2009, we need to provide authority to adjust prices as part of broader Postal Service restructuring legislation. It is unrealistic to expect the Postal Service to function like a business when Congress has imposed pricing restrictions that do not constrain any private sector businesses.

Thank you again, Chairman Lynch for your ongoing leadership to identify policy options for Postal Service restructuring. Based on today's hearing I believe it is clear that the Postal Service should maintain its authority to make profits from work shares and should receive additional authority to adjust certain mail prices to avert losses from magazines and mail flats.

Mr. LYNCH. It is the custom before this committee that all witnesses to provide testimony shall be sworn. Could I ask you both to rise and raise your right hands.

[Witnesses sworn.]

Mr. LYNCH. Let the record show that each of the witnesses has answered in the affirmative.

I am going to now just offer a brief introduction of our witnesses.

Ms. Maura Robinson was named vice president of pricing at the U.S. Postal Service in June 2008. In this role Ms. Robinson is responsible for the pricing of all postal and nonpostal products and services and for providing analytical support and evaluation of all contract pricing and new product initiatives.

Mr. John Waller is a director of the Office of Accountability and Compliance of the Postal Regulatory Commission. Mr. Waller leads the Commission's analysis of Postal Service pricing proposals and oversees technical support for studies including measurement of the Postal Service's performance and impact assessment of major Postal Service network reorganizations.

Each of you will have 5 minutes for an opening statement. When you see the light turn red, you should probably wrap up.

Ms. Robinson, you're now recognized for 5 minutes.

STATEMENTS OF MAURA ROBINSON, VICE PRESIDENT OF PRICING, U.S. POSTAL SERVICE; AND JOHN WALLER, DIRECTOR OF OFFICE OF ACCOUNTABILITY AND COMPLIANCE, POSTAL REGULATORY COMMISSION

STATEMENT OF MAURA ROBINSON

Ms. ROBINSON. Good afternoon, Mr. Chairman and members of the subcommittee. Today I will discuss the Postal Service's approach to setting prices, the impact of the Postal Accountability——

Mr. LYNCH. Could you pull the mic closer?

Mr. CONNOLLY. We cannot hear you.

Ms. ROBINSON. Today I will discuss the Postal Service's approach to setting prices, the impact of the Postal Accountability and Enhancement Act of 2006, and our workshare discount philosophy.

The Postal Act of 2006 enabled the Postal Service to bring new products and services to market more quickly. The additional pricing flexibility helps us better manage our products and services and make them an even greater value in the marketplace.

The new postal law provided different pricing rules for mailing and shipping services. Prices for mailing services may not exceed the rate of inflation based on the Consumer Price Index for the previous 12 months for any class of mail, while price changes for shipping services must produce sufficient revenue above a price floor that covers attributable costs for each competitive product.

Last year the Postal Service announced that mailing service prices would not increase in 2010. Due to the severe economic recession and the electronic diversion of mail, volume has dropped drastically, and we were concerned that a price increase would further contribute to this decline. Instead, to generate additional revenue and stimulate mail growth, the Postal Service implemented pricing incentives, seasonal sales, and a flat rate shipping option. Overall our goal was to foster a long-term pricing strategy that pro-

motes an efficient and cost-effective postal system, and to promote mail volume retention and growth through pricing and product innovations.

We must use postal pricing as a tool to encourage customers to stay in the mail. The mail has great power to deliver customer value and has a demonstrated ability to help customers grow their business. After experiencing a year in which we lost an unprecedented 25 billion mail pieces, the Postal Service's current focus must be on retaining and growing volume. We know that our largest customers are increasingly more likely to mail less if postage prices increase.

Among our financial challenges are products that fail to cover their attributable cost. This is clearly a cause for concern. No business can afford to lose on an ongoing basis billions of dollars on a few products. However, by the same token, no business can afford to take short-term actions that will create long-term irreparable damage to customers. Improving the financial contribution of money-losing products requires focus on both the revenues generated by the product through the prices charged as well as the cost of providing the product.

Recently we announced that we intend to increase prices moderately in early 2011 using the exigent price change mechanism provided in the PAEA. However, as we move forward, we are working to strike a balance between addressing cost-coverage issues and maintaining our customer base. There are no easy solutions. Prices for below-cost products will be increased to address the cost challenges; however, we intend to do so in a judicious and measured way to improve financial performance over time.

The Postal Service has long offered its customers choices through its worksharing program. If a customer presorts and prebarcodes mail, transports it closer to its ultimate destination, or performs other functions that reduce the Postal Service's costs, they pay a lower price based on the cost the Postal Service does not incur.

Workshared mail is among our most profitable mail. The cost coverage for workshared first-class mail letters was 291 percent in fiscal year 2009, the highest for any product. For each dollar the Postal Service spends to process, transport, and deliver workshare first-class mail letters, we receive almost $3 in revenue.

When a discount is discussed in pennies, it's easy to portray changes as minor; however, when you view those pennies in terms of the postage actually paid by our customers, a clearer view of the effects of changes in workshare discounts emerges. A 1-cent increase in prices translates to an average of $9 million in additional postage annually for each of our five largest customers. In an environment of tight budgets, cost cutting, and ample alternatives to the use of the mail, the potential effect of additional expenditures of this magnitude could be severe.

A viable Postal Service can only exist if we offer prices and products that are good customer value. Over the last 30 years, stamp prices have increased at about the rate of inflation and remain a true bargain in today's world. Our mail system cannot survive unless it remains affordable for everyone. If today's actions shortsightedly accelerate the pace of electronic diversion and the search

for alternatives to the mail, it will be difficult to continue to provide the American people with the postal services that they need.

In closing, during tough economic times we continue to achieve record-level cost reductions, maintain high service level, and attain successes with new initiatives for incremental revenue generation.

I'd be pleased to answer any questions that you may have.

Mr. LYNCH. Thank you. Thank you, Ms. Robinson.

[The prepared statement of Ms. Robinson follows:]

UNITED STATES
POSTAL SERVICE

STATEMENT OF
MAURA ROBINSON, VICE PRESIDENT, PRICING
UNITED STATES POSTAL SERVICE
BEFORE THE
SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE
AND THE DISTRICT OF COLUMBIA
OF THE
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES
WASHINGTON, DC

May 12, 2010

Good afternoon Mr. Chairman and members of the Subcommittee. My name is Maura Robinson. Thank you for giving me the opportunity to testify before this Subcommittee. I have been employed with the Postal Service since March 1998 and have served as Vice President of Pricing since July 2008. In this role, I am responsible for the pricing of all postal and non-postal products and services, and for providing analytical support and evaluation of all contract pricing and new product initiatives.

I am pleased to be with you this afternoon to discuss the Postal Service's approach to setting prices, the impact of the *Postal Accountability and Enhancement Act of 2006* (PAEA) on our pricing policies, and their effect on our customers, and your constituents. Under the *Postal Act of 2006*, we have some additional flexibility to manage our products, but also some challenges to overcome, which I shall describe in my testimony today.

The *Postal Act of 2006* provides greater pricing flexibility and it enables the Postal Service to bring new products and services to market more quickly. The additional pricing flexibility helps us to better manage our products and services, and make them an even greater value in the marketplace.

Prices for Postal Service products are set by the Postal Service's Governors and reviewed by the Postal Regulatory Commission (PRC) for compliance with the requirements of the *Postal Act of 2006*. The law divided postal products and services into two distinct categories: market dominant (mailing services) and competitive products (shipping services). Mailing services include products such as First-Class Mail, Periodicals, and Standard Mail, and account for about 88 percent of all postal revenue. Shipping services include products such as Priority Mail, Express Mail, and Parcel Select.

The *Postal Act of 2006* provided different rules for each category. Price changes for mailing services may not exceed the rate of inflation based on the Consumer Price Index (CPI) for the previous 12 months for any class of mail. Price changes for shipping services must produce sufficient revenue above a price floor that covers attributable costs for each competitive product and for shipping services as a whole, an appropriate share of institutional costs. Determined by the PRC, the institutional cost allocation is 5.5 percent of total attributable costs.

Generally, prices for mailing services are adjusted annually in May. However, last October the Postmaster General announced there would be no price increase for mailing services in 2010. Prices for our shipping services are adjusted annually each January, consistent with industry practice.

Due to the severe economic recession and the diversion of mail to electronic alternatives, volume has declined drastically. During fiscal year (FY) 2009, First-Class Mail and Standard Mail, which make-up 94 percent of volume, declined 12.7 percent. The volume for shipping services dropped 12.3 percent during the same period.

To generate additional revenue and stimulate mail growth, the Postal Service continues to aggressively exploit the pricing flexibility provided in the *Postal Act of 2006*. Three such initiatives implemented during 2009 were the Standard Mail "Summer Sale," the Saturation Mail Incentive, and the First-Class Mail Incentive Program. Each of these initiatives offered price incentives on incremental volume to encourage increased mail use. Because of the response to 2009 Summer Sale, the Postal Service will offer a Summer Sale again this year.

Another successful pricing initiative is our popular Priority Mail Flat Rate Box offerings that provide consumers with predictable pricing and low flat rates to anywhere in the country. We also offer price reductions to customers who purchase our Priority Mail and Express Mail services online. For high-volume shippers, we offer Commercial Plus pricing.

Through all of these offerings, the Postal Service is delivering value and encouraging mail growth. Our revenue-generation initiatives during FY2009, which included pricing incentives, seasonal sales, and flat-rate shipping options, showed positive results, even though mail volume overall declined due to economic factors outside of the Postal Service's control.

Overall, our goal is to foster a long-term pricing strategy that promotes an efficient and cost-effective postal system for the American people, and to promote mail volume retention and growth through pricing and product innovations. It is imperative that we use postal pricing as a tool to encourage customers to stay in the mail. The mail has great power to deliver value to our customers, and has a demonstrated ability to help our customers grow their businesses. Through technology advances, such as the Intelligent Mail barcode (IMb), we are providing customers with more information about their mail than ever before, adding additional value in terms of targeting and effectiveness to successfully manage their business.

Yet, at the same time, the Postal Service continues to face formidable financial hurdles. Work hour costs for postal career employees, driven by statutory benefits, are growing at a rate above inflation. Fluctuating fuel costs have a significant effect on our very large fleet of transportation and delivery vehicles. In addition, the number of delivery points is increasing by almost one million new addresses each year. Going forward, it will be vital to continue to seek opportunities to reduce costs as well as increase revenues by better serving ever changing customer needs.

By law, the Postal Service must rely on the sale of its products and services—not taxpayer dollars—to generate revenue and cover the costs of its operations. During 2010 and beyond, the Postal Service will continue actions to increase efficiency, reduce costs, and generate new revenue. These activities will include reducing additional work hours and head count, maximizing operational efficiencies, renegotiating contracts with major suppliers, continuing the freeze on construction of most new facilities, and initiating revenue generation efforts using the pricing flexibility available under the *Postal Act of 2006*.

After experiencing a year in which volume declined an unprecedented 25 billion pieces, the Postal Service's current focus must be on retaining and growing volume. The market for mail is rapidly changing and our customers—households, small businesses, and large businesses—are re-evaluating whether using the mail is their best alternative. More and more, print media including newspapers, magazines, and advertising matter are moving to electronic alternatives. Convenience, cost, service, and tradition all play a role. Based on a comprehensive study of projected mail use, the Boston Consulting Group (BCG) has estimated that volume will decline an additional 20 billion pieces by 2020. BCG also acknowledges that a substantial risk of even larger volume declines exists.

The Postal Service's own analysis shows that our largest customers are increasingly more likely to mail less if postage prices increase. In this challenging economic environment, our customers have tightened their belts and looked for ways to spend less. They are looking for ways to reduce costs and to eliminate activities, including mailing, if lower cost alternatives are available.

Among the many financial challenges that the Postal Service faces are products that fail to cover their attributable costs. In FY2009, the revenue from 14 market dominant products and services fell short of the costs of providing them by a total of $1.7 billion. Notably, three products (Periodicals, Standard Mail Flats, and Standard Mail Parcels/NFMs) amounted to $1.4 billion, or 84 percent, of the shortfall. This is clearly a cause for concern. No business can afford to lose, on an ongoing basis, billions of dollars on a few products; however, by the same token, no business can afford to take short-term actions that will create long-term irreparable damage to an entire industry.

Improving the financial contribution of money-losing products requires focus on both the revenues generated by the product (through the prices charged), as well as the costs of providing the product. In addition, if we raise the price on money-losing products to a degree that mailers reduce their volumes significantly, it is not likely that we could reduce costs quickly enough to account for the volume decline. Thus, a moderate approach is the best way to address these type of issues. The Postal Service recently announced that it intends to increase prices moderately in early 2011 using the exigent price change mechanism. However, as we develop price recommendations for the Postal Service Governors' consideration, we are working to strike a balance between addressing cost coverage issues and maintaining our customer base. It is easy to suggest "just close the gap with prices," if you do not need to live with the consequences of that pricing prescription. "Just closing the gap" would require price increases of 20 to 30 percent for some customers.

Inherently, price increases are a double-edged sword. While they may improve contribution from the mail pieces that remain in the system, a substantial price increase has the potential to cause a devastating volume reduction. This potential may be exacerbated by current economic conditions. For example, over the past two years retail spending has retrenched and consumers have not purchased as many goods and services. Retail catalog merchants (who mail Standard Mail Flats) have made tough decisions on the number of catalogs they will mail based on the expected return on the cost of a catalog. If they do not expect to sell enough merchandise to justify the cost of mailing one more catalog, that catalog will not be mailed. From a postal perspective, we saw a 22 percent decline in Standard Mail Flats volume in FY2009.

Unfortunately, mail volume may not be able to recover. If a cataloger goes out of business, they cannot mail when the economy rebounds. More insidiously, a cataloger who does not mail to a prospective customer faces a much more difficult and expensive challenge when it tries to regain that customer.

Similarly, Periodicals publishers face market conditions that have changed the characteristics of the magazines and newspapers that are mailed. The general decline in advertising has put increased financial pressure on publishers. When you look at a magazine today, it is typically lighter that it was a few years ago. Because we charge postage based on weight, a reduction in advertising pages also decreases the per piece postage revenue from mailed Periodicals. In addition, the remaining higher share of editorial pages pay lower rates, reflecting Congressional policy decisions to grant preferred status for mailing editorial content.

There are no easy solutions. As noted above, if a sudden and dramatic volume reduction resulted from a significant price increase for money-losing products, the Postal Service would not be able to reduce costs quickly enough to account for the volume reduction. Prices for below-cost products will be increased to address the cost challenges; however, we intend to do so in a judicious and measured way to improve financial performance over time. Accelerating volume declines may just exacerbate the cost coverage concerns, reducing efficiencies and increasing costs for the volume that is left.

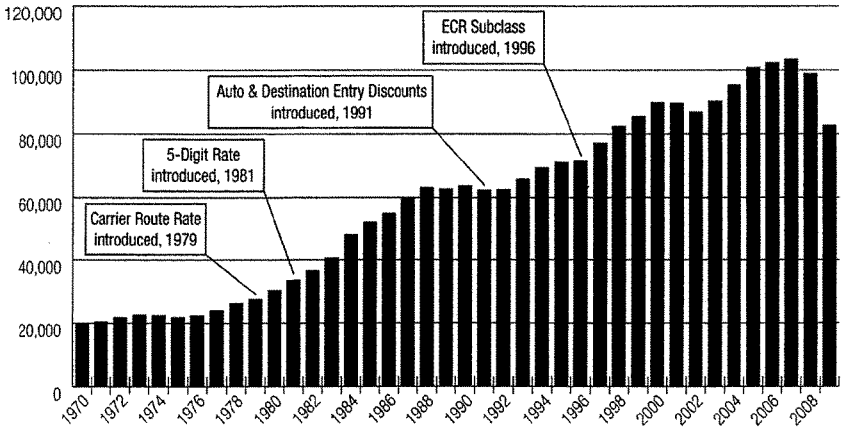
The Postal Service is doing its part operationally as well. Last year, we took over $6 billion in costs out of operations and reduced our career labor force by 40,000 largely through attrition and retirement. We are continuing these efforts and expect to further reduce costs by $3.8 billion this fiscal year.

Our customers have always had choices when they decide whether to use the mail to send a message or merchandise. As the world has become more technically sophisticated, the number of alternatives has multiplied. The emergence of alternative electronic channels such as email, online bill payment, electronic bill and statement presentment, and Internet-based retail catalogs, newspapers, and magazines, has resulted in a dramatic shift in the way the American public communicates and transacts business. While mail is a highly effective way to communicate, our customers are balancing the value they receive from the mail against the often much lower cost of doing business using an electronic medium.

The Postal Service has long offered its customers choices through the worksharing program. Beginning in 1976, the Postal Service developed an array of prices based on how our customers prepare mail. Worksharing has stimulated growth in mail volume. Increases in volume have often followed the introduction of new worksharing discounts or changes in the discount structure.

Workshare discounts result in volume growth, in part, because price increases are kept smaller than they otherwise would have been. If a customer presorts and prebarcodes mail, transports it closer to its ultimate destination, or performs other functions that reduce the Postal Service's costs, they pay a lower price to reflect the Postal Service's reduced workload.

Standard Mail (Third-Class) Volume



Worksharing (presorting, prebarcoding, transportation, and handling) discounts are based on the Postal Service's avoided costs. Typically, workshare prices have been set by considering the level of these avoided costs. If a workshare discount is set exactly equal to the Postal Service's avoided costs, then a customer will workshare if the costs they incur to engage in the worksharing activity (e.g., presort its mail) *are less* than the Postal Service's discount. In the regulatory jargon, when discounts exceed avoided cost, the "passthrough" is greater than 100 percent.

The *Postal Act of 2006* incorporated this view of worksharing when it established the requirement that workshare discounts be set equal to avoided costs, unless certain exceptions are met. As the Postal Service reported in its Annual Compliance Report, some workshare discounts are currently set above avoided costs, but we believe these discounts are clearly permitted by the exceptions outlined in the statute. These exceptions allow the Postal Service to consider whether the reduction or elimination of the discount would impede the efficient operations of the Postal Service, as well as, the effect of price increases (rate shock) on customers if the discount were reduced.

Workshare mail is profitable. There are many myths about worksharing, including an oft-cited observation that if discounts are greater than avoided costs then it must be unprofitable. Nothing could be further from the truth. Despite the sometimes vocal rhetoric, workshared mail is among the most profitable mail for the Postal Service to handle. For example, the cost coverage for workshared First-Class Mail letters was 291 percent in FY2009; the highest for any product. More simply, for each dollar the Postal Service spends to process, transport, and deliver workshared First-Class Mail letters, we receive almost three dollars in revenue. In comparison, for each dollar in cost for single-piece First-Class Mail, we receive only $1.67 in revenue.

From another perspective, in FY 2009 each workshared letter contributed 22.9 cents to help cover the overhead costs of the Postal Service. That is 4.9 cents more than the contribution from the typical single-piece First-Class Mail letter. Significantly, this high margin exists even though the workshare discount exceeds the estimated avoided costs.

Raising prices will reduce volume. Another common myth is that the Postal Service could simply raise the price of workshare mail without any substantial consequences. Unfortunately, this does not reflect the reality of the choices our customers are making on a day-to-day basis. For the vast majority of customers, the choice to retool and redesign processes to enable worksharing was made long ago. Today, they are not deciding whether to workshare; they are deciding whether to mail at all.

Large commercial customers evaluate their decision to mail based on the total cost of mailing. If a workshare discount were eliminated or substantially reduced, most customers would not consider single-piece prices as a viable alternative to the lower workshare prices. Their choice is much more stark—it's a choice between mailing at the current workshare prices or not mailing at all.

When a discount is discussed in pennies, it is easy to portray changes as minor. However, when you view those pennies in terms of the postage actually paid by our customers, a clearer view of the effect of changes in workshare discounts emerges. A one cent increase in prices (due to a decrease in the workshare discounts) translates to an average of $9 million in additional postage annually for **each** of our five largest customers. In an environment of tight budgets, cost-cutting, and ample alternatives to the use of the mail, the potential effect of additional expenditures of this magnitude could be severe. As noted above, the Postal Service would not be able to reduce costs quickly enough to make up for a sudden volume decrease caused by significant price increases.

Customers, large and small, benefit from worksharing. Another in the litany of worksharing myths is the assertion that worksharing harms small customers. This is not true. The Postal Service's workshare prices are available to customers mailing as few as 250 pieces at a time. Today, 80 percent of volume is workshare mail. Civic, religious, and community organizations all use workshare discounts to help keep mailing costs down and make delivering their services as cost-effective as possible. This is truly a case of a penny saved being a penny earned and that can therefore contribute to the ultimate mission of these organizations.

More fundamentally, retaining mail volume from commercial customers helps to maintain the Postal Service's ability to finance universal service. Our business model is one that was built on volume.

A viable Postal Service can only exist if we offer prices and products that are a good value for our customers. The ratemaking structure created by the *Postal Act of 2006* was founded on the principle that new pricing flexibilities were needed to allow the Postal Service to react quickly and effectively to

changing market conditions. As with many new endeavors, while we work through the details of the statutory pricing system, we are finding that certain rigidities exist that may not have been contemplated by Congress. For example, the statutory worksharing requirements could, under some interpretations, substantially limit the Postal Service's pricing flexibility.

While there may be disagreement about details of how the new pricing system should be implemented, there is wide-spread consensus that the intent of the PAEA was to provide the tools that would protect and grow mail volume and provide a flexible, responsive mechanism in which to implement changes in prices and products. A pricing structure that has the perverse effect of driving mail out of the system is not consistent with any reasonable understanding of the new statutory system. Similarly, regulatory interpretations that substantially and unnecessarily limit the Postal Service's pricing flexibility are not consistent with the stated Congressional intent.

Worksharing is one of the areas where this tension between the interpretation of the statutory requirements and flexibility is most evident. This tension is most obvious for First-Class Mail. To be clear, when pricing workshared First-Class Mail, the Postal Service does not ignore the estimated cost differences between workshared and single-piece mail. Under the PAEA, price increases between the workshare and single-piece categories are necessarily interrelated, because the price cap applies to First-Class Mail as a whole. But as a matter of policy, it simply makes no sense to assert that the foundation for the entire workshared First-Class Mail pricing structure must be based solely on avoided costs relative to single-piece mail. If it were, one decision—the level of the stamp price—would determine prices for virtually all First-Class Mail. Pricing would be a purely formulaic exercise in subtracting avoided costs for each level of worksharing and implementing the result. This runs counter to a Congressional cornerstone of the PAEA—pricing flexibility.

A hallmark of the *Postal Act of 2006* was the increased emphasis on pricing flexibility as a tool to retain and grow mail volume. Despite the challenging economic environment, the fact that the PAEA streamlined price change procedures has enabled the Postal Service to be more responsive to our customers. New initiatives such as the Summer Sale, the First-Class Mail Incentive, and shipping services contract pricing, demonstrate that with regulatory burdens reduced, innovation results. It would be ironic if an overly restrictive interpretation of the workshare provisions of the PAEA stifled all pricing flexibility within First-Class Mail, which accounts for almost 50 percent of the Postal Service's revenue and in FY2009 accounted for nearly 72 percent of the contribution to the Postal Service's overhead costs.

I am not arguing that the Postal Service should never increase prices. On the contrary, in our recently issued plan—*Ensuring a Viable Postal Service for America: An Action Plan for the Future*—we set out a direction which clearly describes the need for a moderate exigent price increase. However, we cannot assume that any price increase can and will be tolerated by postal customers. Our largest customers make decisions every day about whether they will mail. If we force our largest commercial customers to make that choice, and they decide that it is no longer economic to mail, there can be profound effects on the volumes within the postal system. Large customers affect large volumes of mail and in the face of double-digit mail volume declines, we cannot afford to take actions that will accelerate the diversion of mail volume to electronic and other means. If we focus entirely on increasing the revenue per piece by a few tenths of a cent to offset an estimated cost avoidance figure, we will risk losing the entire per piece contribution from a very profitable mail stream, as that volume leaves the system.

The Postal Service has long recognized that it is important to protect the prototypical small household mailer—"Aunt Minnie". Over thirty years, stamp prices have increased at about the rate of inflation and remain a true bargain in today's world. However, protecting Aunt Minnie is not just an exercise in protecting the stamp price. It is necessary to protect the viability of the postal system to ensure that it survives to continue to provide service to Aunt Minnie. Our mail system cannot survive unless it remains affordable for everyone. If today's actions shortsightedly accelerate the pace of electronic diversion and the search for alternatives to the mail, it will be difficult to continue to provide the American people with the postal services that they need.

In closing, I speak for the Postal Service leadership team when I say that we are very proud of our accomplishments in meeting the mailing needs of the nation. During tough economic times, we continue to achieve record-level cost reductions, maintain high service levels, and attain successes with new initiatives for incremental revenue generation.

Our Action Plan for the Future is designed to make certain that the Postal Service will remain a vital driver of the American economy and an integral part of every American community. But to fully implement our Action Plan, we need help from Congress to achieve the passage of legislation that will address our near-term and future challenges. This will help to ensure that the Postal Service will be an integral part of the fabric of American life for a long time to come.

We thank you for your support of our ongoing efforts to secure a sound Postal Service. I will be happy to answer any questions that you may have.

###

Mr. LYNCH. Mr. Waller, you're now recognized for 5 minutes.

STATEMENT OF JOHN WALLER

Mr. WALLER. Thank you. Thank you for the opportunity to be here today.

Appropriate pricing can sustain operations and provide postal services for the Nation. To help generate new revenue, the Commission has already approved 40 Service-proposed pricing initiatives this fiscal year, while providing the transparency and review required by law. This builds on the long tradition of the Commission working with the Postal Service and mailing community to develop workshare discounts that over the years have increased volume, revenue, and, most importantly, net revenue.

That experience was incorporated into current law when worksharing discounts were defined as being provided to mailers for the presorting, prebarcoding, handling, or transportation of mail, as further defined by the Postal Regulatory Commission. When mailers perform one or more of these functions prior to mailing, the Service can avoid certain transportation and mail processing costs. If workshare discounts equal avoided costs, then other mailers are not disadvantaged, and the Service retains the same unit contribution to institutional costs.

But when discounts exceed avoided costs, contribution can be lost, and a mailer has price incentives to perform postal functions that the Service can perform at a lower cost. The PAEA explicitly requires the Commission to ensure that this does not occur unless certain specified exceptional circumstances exist.

The difficult computational task is to identify the cost of handling mail that is similar except for being workshared. As an example, consider a first-class letter mailing that satisfies automation requirements and is presorted to the five-digit ZIP code level. The average Postal Service unit cost for processing and delivering this mail is 8.7 cents. However, without presorting and other workshare requirements, the cost is 18.2. The 9.5 difference is the avoided cost.

Methodologies for determining avoided costs have been developed over the years and continue to be refined through public hearings, with input from the Postal Service and other interested parties. Current avoided costs are determined each fiscal year as part of the Annual Compliance Determination process to ensure timely detection of discounts that are too large and need to be realigned.

As noted by the chairman, for fiscal year 2009, the Commission found that 13 worksharing discounts exceeded avoided costs and were not justified by the Service, with exceptions outlined in the PAEA. The Commission has determined that the best time or most appropriate time to realign these 13 questionable discounts is the upcoming exigent rate case.

Last year the Service had a loss of $3.8 billion with $1.7 billion due to 14 market-dominant products that did not cover their attributable costs and contribute to the institutional costs; $1.5 billion came from periodicals, standard mail flats, and standard mail nonflat machinables and parcels. All of these products involved flats for which the Postal Service has a longstanding cost-control problem.

Standard mail flats were given less-than-average increases for the last 2 years, and there has been a rapid increase in losses from that product, with a near tripling in 2009. While this pricing strategy has been given an opportunity to succeed, the Commission has cautioned against continued less-than-average increases for loss-making products without a plan for how net revenue is helped over the long run. First-class and bound printed matter flats do cover attributable costs, so the standard flat mail losses are not an unsolvable problem.

Standard mail nonflat machinables and parcels received significant price increases of 16.4 percent last May and 9.7 percent the year before, well above the average, but more work is needed to fully align revenue and costs.

Periodical has not covered its attributable costs since 1997. The Commission and the Postal Service have a study underway to find out what some of the chronic costs and revenue imbalance causes are. It should be completed this year and sent to the Congress for consideration.

The Commission has emphasized that financial difficulties to the Service is a multifaceted problem, not just a matter of piece—of the prices, but of operating costs, legacy costs, business model and a changing mail market. As solutions are sought, the Commission is responsible for providing transparency on revenue and costs.

Thank you.

Mr. LYNCH. I thank the gentleman.

[The prepared statement of Mr. Waller follows:]

Testimony of John Waller
Director of Office of Accountability and Compliance
on Behalf of the Postal Regulatory Commission
Before the U.S. House of Representatives Committee on Oversight
and Government Reform Subcommittee on Federal Workforce,
Postal Service and the District of Columbia

May 12, 2010

Chairman Lynch, Ranking Member Chaffetz, and members of the Subcommittee, thank you for the opportunity to appear before you to discuss postal pricing issues that are raised in the Commission's Fiscal Year 2009 Annual Compliance Determination.

In fiscal year 2009, the Postal Service experienced an unprecedented drop in volume and narrowly avoided defaulting on its financial obligations. This was due to the rapid economic downturn that was especially damaging for some of the primary users of the mail, and the continued diversion of valuable letter mail to electronic forms of communication.

The Postal Service is no longer able to depend on volume growth to counterbalance the large amount of fixed costs in postal operations. It has had to explore ways to modify its business model, generate new sources of revenue, and modify methods of operation to accelerate the reduction of costs. In the meantime, the Postal Service has responded to the financial crisis with extensive cost cutting efforts, some of which may have contributed to the avoided costs dropping below their workshare discounts. Price modification is only one potential component of the solution set. The need is to bring total costs and revenues into line. While the Postal Service decided this year not to pursue the

regularly scheduled May price adjustments, it has announced an intention to file a notification of an exigent price change to take effect in 2011. The Commission concludes in its Annual Compliance Determination that the upcoming general price adjustment is the appropriate time to address the specific pricing issues that were identified.

Workshare Discounts in Excess of Avoided Costs

Worksharing has proven to be a very successful initiative for the Postal Service. Each new workshare discount has been followed with an increase in volume, beginning with the First-Class Mail discounts introduced in the 70s, Standard Mail discounts in the 80s and then parcel discounts in the 90s. An example of this success involves parcel post which experienced a complete turnaround after workshare discounts became available in 1991. From 1970 to 1990, parcel post volume declined an average of 7.5 percent per year. But for the period 1991 through 2009, volume increased on average 4.8 percent per year.

Workshare discounts, as defined in the Postal Accountability and Enhancement Act (PAEA) are "provided to mailers for the presorting, prebarcoding, handling, or transportation of mail, as further defined by the Postal Regulatory Commission." 39 USC 3622(e)(1). When the mailer performs one or more of these functions, the Postal Service does not have to perform certain mail processing functions, such as cancellation, barcoding, and multiple sorting operations.

When properly designed, workshare discounts can not only increase mail volume and revenue, they can increase net revenue – revenue exceeding attributable costs – and help to defray the institutional costs of the Postal Service. Other mailers are not disadvantaged because the discounts equal the costs avoided or driven out of the system, and the Postal Service retains the same unit contribution to institutional costs. Thus, properly designed workshare discounts act to control costs and create competition within mail processing.

Under the previous postal law, the Commission attempted to consistently recommend workshare discounts equal to the costs avoided by the Postal Service as a result of preparatory work performed by mailers. This pricing principle, which has also used in other regulated industries, is often referred to as Efficient Component Pricing or ECP. As the name suggests, the idea is to develop prices for the individual components of a service with the goal of promoting the efficient use of each component. In the case of worksharing, each discount is effectively the price of a processing or transportation step in the Postal Service's mail handling chain. When a mailer prepares mail to qualify for worksharing rates, it is choosing to perform one or more of those steps itself, rather than pay the price of having the Postal Service do the work.

Worksharing can also benefit the overall economy and society at large. When workshare discounts equal avoided Postal Service costs, mailers can choose to do the work themselves when it is cheaper to do so, or let the Postal Service do it. For example, mailers can sort addresses in computer data bases and then print addresses on mail pieces in ZIP Code or delivery sequence order during the production of mail pieces, which is often much cheaper than physical sorting of the mail pieces by the Postal Service. In this manner, workshare discounts incent mailers to take advantage of technology and utilize Postal Service products at the lowest possible cost. The realized savings can then be used to expand their businesses and perhaps increase their mail volume. This is real productive efficiency.

When discounts exceed avoided costs, the mailer has price incentives to perform postal functions that the Postal Service can perform at a lower cost. In that instance, the discount can introduce inefficiencies in the mail process. The PAEA explicitly requires the Commission to ensure that this does not occur.

As an example of worksharing, consider a set of First-Class letter mail that satisfies Postal Service automation requirements and is presorted to the 5-digit ZIP Code level. The average Postal Service cost to process a piece of this mail from intake through delivery is 8.7 cents. However, if the same mail had not been presorted and otherwise workshared, the Postal Service cost to process a piece of this mail is 18.2 cents. The 9.5 cents difference is the Postal Service cost avoided as a result of a mailer's preparatory work. The current discount for this type of workshared mail is 10.5 cents.

The difficult computational task is to correctly identify the Postal Service cost of handling mail that is similar except for being workshared. Methodologies to determine the cost of various types of worksharing have been developed by the Commission over the years and refined through public hearings with input from the Postal Service and other interested persons. Due to continual changes in postal operations, it is necessary to periodically review how workshare costs are developed. Last year, 30 proposed changes to costing methods were publicly reviewed by the Commission, and 29 were approved.

Also, the actual costs of the potentially avoided operations are updated each fiscal year with data filed by the Postal Service in an Annual Compliance Report. These data are examined by the Commission, are available for public review and comment, and are used to produce the Annual Compliance Determination. This process ensures an accurate measurement of the costs that are actually being avoided by each workshared operation and allows the Postal Service to develop discounts that do not exceed avoided costs. Because the cost of some operations decreased during fiscal year 2009, some existing discounts ended the year exceeding avoided costs. A reduction in postal costs is desirable in these difficult financial times. Identifying these contractions in cost avoidances on an annual basis, and making suitable realignments as soon as practicable, is one of primary purposes of the Annual Compliance Determination.

For Fiscal Year 2009, the Commission found that 30 of 189 workshare discounts exceeded avoided costs, and that 17 of these were justifiable under current law. The PAEA, building on practice under the previous postal law, recognized that under certain situations it is appropriate to have a discount exceed avoided costs, and provided four types of exceptions to the limitation in section 3622(e). They are:

1) The discount is (i) associated with a new postal service, a change to an existing postal service, or with a new workshare initiative related to an existing postal service; and (ii) necessary to induce mailer behavior that furthers the economically efficient operation of the Postal Service. The portion of the discount in excess of the cost that the Postal Service avoids as a result of the workshare activity will be phased out over a limited period of time;

2) The amount of the discount above costs avoided (i) is necessary to mitigate rate shock; and (ii) will be phased out over time;

3) The discount is provided in connection with sub-classes of mail consisting exclusively of mail matter of educational, cultural, scientific, or informational value; or

4) The reduction or elimination of the discount would impede the efficient operation of the Postal Service.

The Postal Service provided reasons why it believed each of the 30 questionable discounts satisfied one or more of the exceptions. For instance, the shortfalls pertaining to Periodicals meet criteria in exemption 3.

In some instances, the Postal Service could identify how operations would deteriorate and harm overall efficiency if the specific discounts were reduced and

cited exception 4. An example of this is the workshare discount for Standard Mail machinable parcels presorted to the 5-digit ZIP Code level. The Postal Service explicitly identified how operations would become more inefficient without the extra inducement to presort these parcels. The Commission found that justifications provided for 17 of the 30 questionable discounts were acceptable under the PAEA.

For the other 13 discounts, the Postal Service did not provide adequate justification for the discounts exceeding avoided costs. In most of these instances, the Postal Service stated that a rate adjustment would harm efficiency without identifying how this would occur. The Commission determined, however, that while rate adjustments represent a possible remedy to workshare discounts greater than avoided costs, such adjustments are not, of themselves, a cause for inefficiency in Postal Service operations.

Once a determination is made that a workshare discount that exceeds avoided costs is not justified by one of the four exceptions in the PAEA, the Commission is authorized under section 3653(c) to order appropriate remedial action. In the fiscal year 2008 Annual Compliance Determination, the Commission found several workshare discounts that exceeded avoided costs without adequate justification. However, at that time the Commission also was reviewing a general price adjustment in which the Postal Service was remedying the identified problem discounts. Thus, no additional action was necessary on the part of the Commission. This year, however, there was no regularly scheduled May price increase in which the questionable discounts could be modified. But on March 2nd of this year, the Postal Service stated that a notice of an exigent price adjustment for early 2011 would be forthcoming. The Commission determined that the adjustment of all or some of the 13 questionable discounts could be best addressed at that time.

Products Not Covering Costs in FY 2009

Postal Service costs fall into two categories: those caused by specific products, referred to as attributable costs, and the remaining costs that are commonly referred to as institutional costs. Revenues from many postal products exceed their attributable costs and make a contribution to the institutional costs. But last year, contributions from the various postal products were insufficient, and the Postal Service had a loss of $3.8 billion. Of that loss, $1.7 billion is due to 14 market dominant products that did not even cover their attributable costs. Most businesses cannot continue to operate over long periods with products that do not cover attributable costs.

For the Postal Service, this shortfall problem is somewhat confined. Nearly $1.5 billion of the loss from products not covering attributable costs comes from just three products: Periodicals, $642 million; Standard Mail Flats, $616 million; and Standard Mail Non-Flat Machinables (NFMs) and Parcels, $205 million. Losses for the two Standard Mail products have significantly increased from the prior year. Also, there is an important cost causing factor common to these three products. Specifically, they all involve the handling of flats for which the Postal Service has long standing cost control problems.

In the fiscal year 2000 rate case, the Commission required the Postal Service to explain why the cost of handling flats was increasing so rapidly, and how the Postal Service intended to solve this problem. The answer was new machinery and better management techniques. That equipment, the Advanced Flats Sorting Machine, did make some dent in the problem, but the flats handling cost problem has continued. The new Flats Sequencing System equipment now being deployed is frequently cited by the Postal Service as a future source of cost savings. This remains to be seen. In the interim, the Postal Service, has given Standard Mail Flats less than average increases for the last two years in hopes of retaining flats volume until the cost savings can be realized. The impact

has been a rapid increase in the losses from Standard Mail Flats with a near tripling in 2009. While this pricing strategy has been provided an opportunity to succeed, the Commission in recent Annual Compliance Determinations has cautioned against less than average increases for loss making products without a plan or justification for demonstrating how net revenue is helped over the long run. The 2009 Annual Compliance Determination notes that while Standard Mail Flats experienced a significant loss, First-Class and Bound Printed Matter Flats do cover attributable costs so it is not an unsolvable problem.

Standard Mail NFMs and Parcels consist of approximately 1.3 million NFMs and 5.5 million parcels both of which are costlier to handle than letters and flats. The product consists of boxes of checks, boxes of gift cards, and other promotional items. If these products were handled through Parcel Select, a competitive product, the price to the mailer can approximately double that of the Standard Mail rate. Recognizing the high cost of processing these items, the Postal Service has provided pricing incentives to have the product workshared to facilitate the most efficient handling by the Postal Service. At the same time, the Postal Service has attempted to increase revenue through price increases: a 16.4 percent increase last May and a 9.7 percent increase the year before. These increases were well above the average Standard Mail increases of 3.7 and 2.8 percent, respectively. Without these increases, the losses would have been even greater. The Commission has requested that the Postal Service develop a plan this year to resolve this cost and revenue imbalance.

Periodicals Mail revenue has not covered attributable costs since 1997. Revenue nearly equaled costs in 2003, but the gap has steadily increased since. For fiscal year 2009, revenue covered only 76.1 percent of the costs directly attributable to Periodicals Mail. As required by the PAEA, the Commission and the Postal Service are jointly studying Periodicals costs and operations to identify opportunities to fix the chronic cost and revenue imbalance. This study should be completed later this year and sent to the Congress for consideration. What

has become obvious is that the problems in handling Periodicals flats are even more pronounced than in Standard Mail. The Periodicals industry also has been seriously impacted by the recent economic and technology-driven changes. These changes have caused significant drops in the advertisement in Periodicals and less weight per piece. These changes negatively impact postage revenue since the non-advertising portion of a Periodical receives lower rates and over 30 percent of Periodicals revenue is based on weight.

The Commission directed the Postal Service to address the issue of products that were found to not cover costs in its next general market dominant price adjustment. In instances where a problem cannot be fully resolved at that time, the Postal Service is to provide a detailed plan for future resolution.

In summary, the overall losses are not solely the problem of these three products. The cost and revenue of all products need to be addressed. As the Commission emphasized in its 2009 Annual Compliance Determination, the financial difficulties of the Postal Service is a multifaceted problem, not just a matter of prices, but of operating costs, legacy costs, business model, and a changing mail market. In the meantime, the Commission is responsible for providing transparency on the revenue and costs of postal products and recommending appropriate actions when problems are identified.

This completes my testimony. I will be glad to answer any questions you may have.

# # # #

Mr. LYNCH. Let me just—I will yield myself 5 minutes for questions, but before I do, why don't we do this: Before I move to questions and begin my time, I would like to ask unanimous consent that the statement from the National Newspaper Association, which highlights their concerns over postal pricing for in-county newspapers, be included for the record.

Hearing no objection, so ordered.

[The information referred to follows:]

National Newspaper Association
Washington Office
PO Box 5737
Arlington, VA 22205
703.237.9801
Fax: 703.237.9808
Web Site: www.nna.org

May 12, 2010

The Honorable Stephen Lynch
Chairman
Subcommittee on the Federal Workforce, Postal Service and the District of Columbia
B349-A Rayburn House Office Building
Washington, DC 20515

Dear Mr. Lynch:

On behalf of the National Newspaper Association, a 125-year old organization representing 2,000 members that publish community newspapers, we offer some observations and concerns for the record of the subcommittee's May 12 hearing on work-sharing discounts and "under-water" mail classes.

NNA's members include weekly and small daily newspapers across the United States, most of which depend heavily upon the mail for distribution. Most of our member newspapers have no private carrier force; even many of the daily newspapers increasingly rely upon USPS for delivery. The Within-County periodicals mail subclass is dominated by these newspapers. Eligibility to use this mailing subclass, which has received no federal subsidy since 1994, is restricted by Congress to newspapers with circulations under 10,000 or whose distribution is primarily within its county of publication.

NNA works closely with other members of the Periodicals community on public policy, mail preparation and service issues common to all Periodicals. Indeed, newspapers are also heavy users of Outside County Periodicals mail to reach readers within their markets but outside county lines, as well as those further away—such as students and snowbirds. However, the larger Periodicals mailers cannot speak for Nna or the Within County mailers. The Within County subclass is known to be NNA's primary concern, and the organization freely offers its counsel on this subclass to the Postal Service, the Postal Regulatory Commission and members of the Congressional oversight committees. We have appreciated the support of Congress over the years for maintaining this important subclass, which stems from an act of Congress in 1851.

Within County mail must be analyzed separately from the Outside County dominant subclass within Periodicals. Although both subclasses are formally "under-water" according to USPS statistics, there is reason to be skeptical of the perception that Within County mail is being subsidized. There are several reasons for this skepticism:

1. According to the Postal Service's most recently filed Billing Determinants covering the first quarter of Fiscal Year 2010, this mail is highly presorted. The report indicates that 81% of this mail is sorted by publishers to the carrier route and over half of the mail is transported by publishers directly to the delivery post office. Unlike Outside County Periodicals that require greater transportation and mail processing costs, the Within County newspaper mail requires only minor sorting—almost all performed at the carrier station, or even at the mailbox—and very little transportation. Some walk-sequenced mail can be delivered as a third bundle, and does not even require casing by the carrier. If mail processing costs are the root of the Postal Service's concerns over below-cost mail, this subclass is highly unlikely to be a part of the pool of problems.

2. The Postal Service has opined that a part of the problem in Outside County Periodicals derives from a shrinking advertising base. Because the complex postage calculation for Outside County mail involves a higher rate for advertising pounds of mail than for editorial pounds of mail, shrinkage of advertising in magazines and newspapers may play a role in concomitantly shrinking postage. But the Within County rate is calculated only by pieces and pounds, with some adjustments for work sharing by publishers. A growing editorial share or a shrinking advertising share in a publication would play no role in the postage bill.

3. The small size of this subclass—although a critical one to community journalism—is problematic for the Postal Service. It represents less than a half of one percent of the market dominant classes total mail volume and a little over 10 percent of the total Periodicals mail volume. As a result, when costs are calculated, USPS relies upon estimates and proxies in several of its key costing segments. It finds in its cost-sampling systems that Within County mail pieces are simply not detected often enough for high reliability of cost estimates. Similarly, because much of the Within County mail volume appears in rural areas, where the automated Postal One accounting and management systems have not yet reached all post offices, USPS relies upon statistical samplings of small post offices to calculate mail volumes. In the most recent cost-of-service omnibus rate case, the PRC required the Postal Service to average several years of volume to come up with a more accurate mail count. PRC has also on numerous occasions requested better statistical data for this subclass, and has reported to Congress on unreliability of data for the smaller subclasses. Thus, while there may be problems with the true cost of this mail, an inability by the best of experts to reliably identify the true cost of this mail makes reports of concerns somewhat suspect.

4. Oddly enough, in an age where the Postal Service fears massive losses of volumes, this small subclass has played a part in providing growth. In Fiscal Year 2008, Within County mail actually grew 12.8 per cent, then another 3.4 percent in 2009 while total Periodicals mail fell 8.7 percent. The first quarter of FY 2010 reaffirms the trend: Within County Mail was up 1.6 percent while Outside County fell 11.4%. NNA believes much of this growth derives from the conversion of small daily newspapers from private carriers to the Postal Service. NNA notes that this conversion will be reversed if USPS drops Saturday mail delivery, as daily newspapers will once again be required to form private carrier forces.

5. Finally, during recent meetings with USPS over the problems of "under- water" Periodicals mail, we were told that while Periodicals costs rose about 7.4 percent in the latest fiscal year, about 7 percent of that cost increase was simply from the combined wage and cost of living increases of the employees' contracts. If that is the case, the situation appears to be more one of the revenue of mailers being unable to keep up with planned labor increases that were obviously set in a very different economic era. One would hope that with the Postal Service's attention to costs in the coming years, small mailers like NNA's members will confront a more contained human resource cost. Certainly in an industry like newspapers, which have sustained layoffs, furloughs and downsizing in tight years, the prospect of ever-rising human resource costs in distribution is disturbing.

NNA appreciates this opportunity to comment and looks forward to working with you and the subcommittee in the coming months, as the critical questions facing the Postal Service are considered.

Sincerely,

Max Heath
Shelbyville, KY
Chairman, NNA Postal Committee

Tonda F. Rush
NNA Washington Office/Arlington VA
Director of Public Policy

Mr. LYNCH. All right. Just so this doesn't get too technical, I want to, first of all, try to offer a little bit of an explanation to the folks who are unfamiliar with this process about workshare. Workshare simply refers to the portion of work that mailers conduct when they bring their mail—before they bring their mail to the post office, and that can involve presorting. If a mailer has a lot of mail, and they bring it to the post office and it's presorted, it can be barcoded, it can be bundled in ZIP codes and actually transported privately to the Postal Service rather than picked up so that private mailers are doing a lot of work that the Postal Service might have otherwise done, and that's what we call workshare. And the idea of these discounts is really trying to determine what the value of that presorting, bundling, delivery, barcoding, the things that they have done for the Postal Service to make the delivery more efficient. And so we try to give them a discount that exactly matches the service that they have provided.

The problem begins when on the one hand sometimes we overcompensate the mailers. We give them more of a discount than the value of the services that they provided, which ends up in a boon or a windfall, some say, to the mailers and an inefficiency or a lack of valuing of the service provided by postal employees. On the other hand, sometimes we shortchange our mailers, and we don't give them enough of a discount, and in that instance you actually have an antitrust problem or a situation where the Postal Service is actually retaining revenue or taking advantage of the mailers.

So that's where we have these differences. And hopefully that's a little bit clearer than just using terms like "workshare" and "cost avoidance" and other things like that.

Let me ask you, during the Postal Service's March 2, 2010, announcement of its new business plan, the post office stated that their goal was to have all products covering their costs. Now, we have several general categories of mail that actually cost more to deliver than what we charge, and so those products do not meet the cost of delivery based on the rates that we charge. How do you plan to meet your goal of having all products covering their cost by 2020 based on the situation we have right now?

Ms. Robinson.

Ms. ROBINSON. As I've indicated, there are problems with some of our products that do not recover our costs, and that's not a situation that is sustainable for any organization. The Postal Service is looking at all alternatives to grow mail volume, to increase our revenue from those products, and to operate with those products as efficiently as possible. More practically we're going to be addressing the pricing issues through, in part, an exigent price increase which will be filed later this year in which we intend to have a moderate price increase that will in part address the cost challenges within products such as standard mail, flats, and periodicals.

Mr. LYNCH. OK. Let me interrupt there. So we have flats, which you've got magazines and catalogs, things like that, that are not currently paying for themselves. We're subsidizing the delivery of those products. They're awkward, but large; they're odd sizes. Then give me another area where we are mispricing.

Ms. ROBINSON. The three largest categories where you're not covering costs would be periodicals, magazines and newspapers.

Mr. LYNCH. Right.

Ms. ROBINSON. Standard mail flats, which is typically catalogs and other large paper-size pieces of advertising mail, and standard mail parcels, which are lightweight parcels weighing under——

Mr. LYNCH. How are we going to bring those up to a category where they pay for themselves?

Ms. ROBINSON. We're looking at increasing the product prices over time. We are going to be doing it in a measured way over approximately a 10-year horizon.

Mr. LYNCH. All right.

Ms. ROBINSON. However, we do need to address the customers' concerns that we don't severely damage their businesses by price increases that are too large.

Mr. LYNCH. Let me ask you—and my time is running out. You say in your testimony that through this exigent pricing or emergency pricing adjustment that we're going to do in 2011 that you're going to institute a, "moderate increase." Give me a hint on what you mean by "moderate." Is there a percentage that you can attach to that or something that I would be able to divine what the cost might be as opposed to being moderate?

Ms. ROBINSON. The Postal Service's Board of Governors is going to make that decision, and we're looking at balancing the impact on our customers versus the Postal Service's need for additional revenue and to address the cost challenges.

Mr. LYNCH. Do you have a moderate range? Can you give me a range of between what and what, what that might cost, or are you afraid of scaring people?

Ms. ROBINSON. That's a decision that's going to be made by the Postal Service's Board of Governors, and they've not made that decision yet.

Mr. LYNCH. OK. I've used up all my time.

The chair now recognizes the gentleman from Utah Mr. Chaffetz for 5 minutes.

Mr. CHAFFETZ. Thank you, Mr. Chairman.

Ms. Robinson, you say in your testimony here, if I'm reading it right—at least on page 5 of the copy that I have here, it says: "Workshare mail is profitable. There are many myths about worksharing, including an oft-cited observation that if discounts are greater than avoided costs, then it must be profitable. Nothing could be further from the truth. Despite the sometimes vocal rhetoric, workshare mail is among the most profitable mail for the Postal Service to handle."

So you cited three areas where you say it's not profitable, and yet in your testimony you also say it's very profitable. What are those areas where maybe we're not giving enough discount? You cited three where we're maybe going the opposite direction, but what are we overcharging for?

Ms. ROBINSON. Well, I'm not sure I would characterize it as overcharging. For example, in workshared first-class mail letters, typical pieces, bills, statements, correspondence you would receive from other businesses, the cost coverage——

Mr. CHAFFETZ. But we're not giving them enough discount; is that what we're saying? Because as the chairman pointed out, there are some legal implications for not passing it along, and if

you're citing things that are saying, well, these are unprofitable, but the overall category is very profitable, what are those areas, specific items, that you're not giving enough discount for?

Ms. ROBINSON. I would not characterize it as not giving enough discount. The discounts are greater—greater than the avoided cost, which is one factor to consider. We're also evaluating the net contribution of, for example, first-class mail letters, which is very high, and the potential effect on customers if we reduce the discounts, effectively increase the prices for those customers. Categories such as standard mail flats, which are some—a fairly workshared category, do have fundamental cost challenges that we're addressing for operational——

Mr. CHAFFETZ. Are there specific categories, specific pieces of mail that we're not giving enough of a workshare discount to?

Ms. ROBINSON. I think there are specific categories of mail where we need to very seriously consider the effects of——

Mr. CHAFFETZ. You can't name any right off the top of your head right now? Because you've named some that you felt like—you know, periodicals and that sort of thing.

Ms. ROBINSON. I think the first-class mail is a category where we have high profits. It's a very profitable source of mail for the Postal Service. I would not characterize the discounts——

Mr. CHAFFETZ. And you won't be seeking a rate increase in those categories, correct?

Ms. ROBINSON. No. When we look at increasing prices through the exigent price mechanism, we will be looking at increasing prices for all mail.

Mr. CHAFFETZ. Even if it's in that most profitable area?

Ms. ROBINSON. Yes. First-class mail is contributing about 70 percent of the contribution to the institutional costs of the Postal Services. Given the Postal Service's financial condition, we can't afford not to increase the price of that mail as well as the prices of other categories.

Mr. CHAFFETZ. If the volume had stayed the same, would we be having the same discussion, or is it directly related to volume?

Ms. ROBINSON. It is in part related to volume and to the pressures in the industries in which our first-class mailers do business, but given the financial pressures on the Postal Service, we believe that we——

Mr. CHAFFETZ. But I'm saying those financial pressures, if the volume had remained the same—and I understand and appreciate that we've taken a precipitous dip. If they had stayed the same, would we be having the same discussion? Would there need to be this discussion happening?

Ms. ROBINSON. I think if the volume had remained the same, the financial circumstances facing the Postal Service would obviously be substantially——

Mr. CHAFFETZ. Would we still be upside down, do you think, or in the red?

Ms. ROBINSON. If the volume had remained the same, there are some pressures on the Postal Service financially associated with retiree health benefits and some other fundamental issues, with at least the secular decline associated with electronic diversion. If the volume remained the same, I think the Postal Service would be

moving forward on a typical schedule for price increases under the price cap.

Mr. CHAFFETZ. One of the things, Mr. Chairman, that I still struggle with is clearly in your testimony and just the basic economics, you say raising prices will reduce volume.

Ms. ROBINSON. Yes.

Mr. CHAFFETZ. But you also say at the same time one of the biggest challenges or opportunities, if you will, for the Postal Service is to increase volume. And that's where there's a disconnect that I just worry about, the accounting of how we try to go and institute. It's the basic question. It's the multibillion-dollar question. I realize how difficult it is to come to the conclusion.

Mr. Waller, I've only got seconds here, but is there anything you would like to address in the questions I asked? I'm sorry I didn't——

Mr. WALLER. Yes. In the ACD, if you look in chapter 7, there's a list of all the products that are either above or below or equal to avoided costs.

Mr. CHAFFETZ. And is there anything in that list that you think arises above and beyond what the legal prescription is for——

Mr. WALLER. Well, there are those that are greater than 100 percent, and that's the legal prescription that is in the PAEA.

Mr. CHAFFETZ. But there are some that are in excess of 100 percent.

Mr. WALLER. Yes, there are. There were the 14 that we identified, and they are—yes, and there are some big volumes there, too.

Mr. CHAFFETZ. Thank you.

Mr. Chairman, I just ask unanimous consent to enter into the record a Congressional Research Service report entitled, "Postage Subsidies for Periodicals, History and Recent Developments," dated January 22, 2009, and I would like to add that to the record.

Mr. LYNCH. Without objection, so ordered.

Mr. CHAFFETZ. I yield back the balance of my time. Thank you.

Mr. LYNCH. The chair recognizes the gentleman from Virginia, Mr. Connolly, for 5 minutes.

Mr. CONNOLLY. Thank you, Mr. Chairman.

We just had a discussion about the fact that the pricing of certain items, magazines, catalogs, might raise antitrust issues. Making a profit rather than taking a big loss might raise antitrust issues. Has that issue ever been adjudicated?

Ms. ROBINSON. Not to my knowledge.

Mr. WALLER. And I think the area of concern is in the worksharing discounts. If it's equal to 100 percent, you're sort of neutral on the—whether the Postal Service does it or competitors.

Now, a lot of businesses have come into existence like consolidators, and they do—they make their money by doing the—getting lots of mailers' mail together and doing it cheaper than the Postal Service, sharing that with the mailer, and they depend upon a fair discount in order to stay in existence. So I think that's where some of the charges you set—a competitive world has been set up in mail processing and if that gets restricted. Now, the Commission has not been involved in any decisions on that I'm aware of and——

Mr. CONNOLLY. It just seems to me that when we're losing $7 or $8 billion a year of taxpayer money, frankly revisiting some of those assumptions and some of those nice things to do for competition might be in order, because our first obligation isn't to private sector competition; while we welcome that, it is to the taxpayers who are ending up helping to subsidize——

Ms. ROBINSON. I'd just like to——

Mr. CONNOLLY [continuing]. These losses.

Ms. ROBINSON. I'd just like to point out that the Postal Service does not receive taxpayer dollars. Our revenue comes from the postage that our customers pay.

Mr. CONNOLLY. All right. Those customers are our constituents, and they are still subsidizing those losses. Otherwise, you wouldn't periodically, when we have hearings like that, be bringing those losses to our attention and the need for urgent action.

Your testimony, Ms. Robinson, notes three products—periodicals, mail flats, and standard mail parcels—fell short of covering their cost by $1.4 billion last year. The PRC's most recent Annual Compliance Determination cautioned against less-than-average price increases for loss-making products without a plan for increasing net revenue in the long run. Does the Postal Service currently have a long-term plan to ensure that those products increase in that revenue?

Ms. ROBINSON. Yes. The Postal Service is developing a long-term plan to address those issues. We are going to be increasing the prices of the products that are not covering their costs in a measured way to address the issue, while maintaining the—limiting the effect on the customer base.

Mr. CONNOLLY. So you're working on a long-term plan.

Ms. ROBINSON. We are developing a long-term plan that will include a price increase using the exigent price mechanism that will be filed with the Postal Regulatory Commission later this year.

Mr. CONNOLLY. Any idea when we might expect to see that long-term plan?

Ms. ROBINSON. That will be up to the decision of the Board of Governors. We should be seeing it relatively shortly.

Mr. CONNOLLY. Relatively shortly. OK.

The chairman talked about the workshare discounts, and again, the PRC in its Annual Compliance Determination found that 30 of those workshare discounts exceeded their avoided costs, 17 of them justified under statutory exceptions, 13 not justified. How do we intend to go about correcting those 13?

Ms. ROBINSON. The Postal Service believes it justified the workshare discounts that exceeded avoided costs largely based on the potential effect of the efficiency of the Postal Service——

Mr. CONNOLLY. I'm sorry, Ms. Robinson. I cannot hear you.

Ms. ROBINSON. I'm sorry. The Postal Service believes it justified those discounts based on the efficiency exception within the statute. Reducing those discounts, effectively increasing the prices for those products, would cause a reduction in volume that we are concerned would substantially reduce the volume to our system and hamper the efficiency of the system. So we believe we've addressed the issues surrounding those discounts.

Mr. CONNOLLY. Thank you.

Mr. Waller, I'm going to run out of time, so let me ask quickly, in general how often ought rate adjustments be made to realign avoided costs with the workshare discounts?

Mr. WALLER. Well, they're on—we're on sort of a yearly cycle now because that's the way the costs come together. Very expensive to find out what each product costs, what each activity costs, and there are a lot of surveys and things that go on. So we're sort of tied into an annual cycle, and that probably is appropriate because you will catch it before it goes on too long.

Last year the—at the beginning of the year, there were a lot of the discounts that were exactly equal to 100 percent. Actual mail-processing costs dropped, and therefore the discounts were too large then. It was caught this year, and the adjustments can be made in this next rate case.

Mr. CONNOLLY. Thank you, Mr. Chairman.

Mr. LYNCH. Thank you.

The chair now recognizes the gentleman from Maryland, Mr. Cummings, for 5 minutes.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

First of all, thank you all for being here today, and I just want to—Dr. Riley, whom we're going to hear from in the next panel, says that—in his testimony, he says that "in the 1990's, management began to view the primary customer of the post office as the larger mailer instead of the individual customer. These representatives focus on obtaining discounts for their clients, the large mailers, and/or converting first-class mail to less expensive categories of mail."

I wanted to give you all a chance to respond to that. What do you think of that? Do you agree with him?

Ms. ROBINSON. During the 1990's, we did see a substantial growth in commercial mail in what would be considered to be the workshared categories. That was in part in response to incentives that the Postal Service put forward through the workshare discount program. That mail helped to drive the automation program in the Postal Service that kept costs low for all customers, including the individual household customer. So there's been a large expansion of the efficiency of the Postal Service that has been in part enabled by the existence of very high-quality, clean mail that efficiently runs in operations that helps to keep the total cost of processing mail down.

The Postal Service looks at the typical household mailer as very important to us. That's our fundamental customer base, and we're very interested in preserving the mail for the typical household customer, and in part we need to do that by preserving the financial stability of the Postal Service and managing our pricing and product structures for commercial customers so they stay in the mail, to enable the typical household customer to continue to be able to have a viable Postal Service for the future.

Mr. CUMMINGS. Mr. Waller, do you have a response to that?

Mr. WALLER. Yes. The importance of having the discount equal avoided cost is that it doesn't put the burden of the discount on the small mailer—on the individual mailer. No other mailer has to pick up that extra institutional cost that might be given away by having a discount larger than the avoided cost. I think that's why it got

put in the act, so that the Commission should ensure that doesn't occur. That's the way to protect not only the small single-piece mailer, but all the other mailers in the system, too.

Mr. CUMMINGS. Mr. Waller, you testified that the Postal Service has had longstanding cost-control problems with the handling of mail flats, is that right?

Mr. WALLER. Yes.

Mr. CUMMINGS. And would you give me a little bit more explanation on that?

Mr. WALLER. Well, the reason I say "longstanding" is back when I was first kind of with the Commission in 2000, the—it was tracking the costs, and periodicals were still going up at that time, and they were mainly flats. So the Commission said, Postal Service, send over some witness, explain what's going on. And basically what was happening was that the automation or mechanical processing equipment wasn't really helping that much. A lot was still being manually sorted, and the promise was, well, we've got a new system coming, the AFSM–100. It did help a lot, but still those costs seemed to spiral out with too much manual sorting and too—too expensive handling costs on the flats.

Now the answer is supposedly in the FSS, but we'll have to see the flats sequencing system, if that actually produces any savings. It just has maintained itself as the high cost of handling flats. It hasn't gotten a handle on it yet.

Mr. CUMMINGS. Now, you also state that due to the continual changes in the postal operations, it's necessary to periodically review how workshare costs are developed. And who conducts those reviews?

Mr. WALLER. The Commission does. The—we have order—or procedures for what data the Postal Service is to provide so we can track those costs. And as I said a moment ago, what happened in 2009, some of those avoided costs, the Postal Service found a way to perform them in a less expensive way. So the costs avoided were less, so, therefore, the discounts should be dropped and appropriately adjusted. And it's on that ground that you have to continually look at that, because if suddenly something becomes operational, some magical way of processing, you want to build that in as costs are less now, less give, less discounts.

Mr. CUMMINGS. I see my time is up. Thank you, Mr. Chairman.

Mr. LYNCH. I thank the gentleman.

The chair now recognizes the distinguished gentleman from Missouri, Mr. Clay, for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman, and thank you for conducting this hearing.

Ms. Robinson, we recently held hearings in this committee regarding the Postal Service's uncertain financial future. In your opinion, how much do issues with workshare discounts factor into the Service's financial woes? Any contributing factors?

Ms. ROBINSON. Clearly you need to evaluate all pricing in relation to the Postal Service's financial position. I'd like to observe for the majority of first-class mail workshare, which is most of the workshare mail, we are actually making 5 cents more per piece for that mail than we do on single-piece mail. This is highly profitable mail, and continuing that workshare program is very important for

the Postal Service. Some categories that are cost-challenged, such as standard mail flats, are very heavily workshared. We're looking at addressing those issues over time.

Mr. CLAY. OK. It has been reported that the Postal Service predicts the rate increase being proposed through the exigent circumstances appeal is moderate. Can you elaborate on this assessment?

Ms. ROBINSON. The Postal Service's Governors are evaluating the current situation, and are going to be making a decision on the size of the increase. That will be announced in the near future. At the moment we do believe the circumstances facing the Postal Service meet the exigent conditions. They are extraordinary. These are really dramatically challenging financial times for our customers.

Mr. CLAY. So do you think there will be a rate increase and it will make up for the difference?

Ms. ROBINSON. As we announced on March 2nd, we are planning a rate increase in early 2011.

Mr. CLAY. OK. In July 2009, the Postal Service filed a request with the PRC to alter their revenue analyst method. Can you explain what this methodology has to do with workshare costs and the Postal Service's financial viability?

Ms. ROBINSON. The revenue—I'm sorry?

Mr. CLAY. It's called the—they filed a request with the PRC to alter their revenue analysis methods. You're not familiar with that?

Ms. ROBINSON. I'm——

Mr. CLAY. OK. Well, I will go on to the next question, then.

Mr. Waller, can you respond to that?

Mr. WALLER. Oh, well, last year we talked about how you have to relook at these costs all the time. The Postal Service last year filed 30 different requests for modification, the way costs are calculated. Twenty-nine of those, in fact, were approved. One was denied. But—so that's an ongoing process. But they came in through the year, some of them in July, some of them earlier and later.

Mr. CLAY. OK. A question for either one, and both of you can tackle it if you would like. How much do products which do not cover their attributable costs factor into the financial hardships of the Postal Service? How much of that adds to your deficit?

Ms. ROBINSON. In fiscal year 2009, the products that did not recover their costs cumulatively lost $1.7 billion.

Mr. CLAY. And the overall loss to the Postal Service was how much?

Ms. ROBINSON. About $3.8 billion.

Mr. CLAY. OK. So it was almost a half or——

Ms. ROBINSON. Yes.

Mr. CLAY. Or over a half.

Go ahead.

Ms. ROBINSON. Pardon me?

Mr. WALLER. No. I agree with that. And not only did they not cover their costs, then they did not create an extra contribution to the institutional cost, which is part of the act, too. They're supposed to make a reasonable contribution to institutional costs. So those products actually had a larger impact.

Mr. CLAY. OK. How can workshare issues be addressed overall to ensure that the Postal Service gets maximum productivity? How do we address that, Mr. Waller?

Ms. ROBINSON. When we look at our customers, we need to look at what they're using the mail to do. We're talking a lot in terms of discounts, price differences between different categories of mail. In reality our customers pay prices. They pay dollars out of their pocket to mail, to accomplish their business objectives. As we look at improving the financial condition of the Postal Service, we need to keep the mail affordable for those customers.

We need to weigh the efficiency concerns around workshare discounts. We need to weigh the fact that our customers have a lot of alternatives to the mail. The number of electronic possibilities for sending a bill, a statement, the information that would be in a newspaper or magazine is growing, and we need to consider that as we price our products.

Mr. CLAY. Thank you.

Thank you, Mr. Chairman. I yield back.

Mr. LYNCH. Thank you.

Let me ask you in light of the gentleman's question, the $1.7 billion delta here in terms of products that do not support the cost of delivery; so we're losing money on certain aspects. I know that Congress, very early after the establishment of the Postal Service at the very birth of our country, made some conscious policy decisions back then that newspapers and periodicals, because they had an informative dimension to them that served the public purpose—this was back in the day when they did not have radio, they didn't have TV, they didn't have 25 news stations, they didn't have the Internet. Congress made a decision back then as public policy that we needed to subsidize newspapers and periodicals because that's how the populace was informed. That was the decision 200 years ago.

Today you can click around, and it's just nonstop news on every single channel. You've got the Internet, all kinds of blogs and Web sites and radio. You've got an abundance of sources for informing the electorate, our citizenry.

In light of that change in technology and in our daily lives, are we still justified in granting discounts to newspapers and periodicals, the cost of which is borne by others who are paying the freight for those periodicals and newspapers? Do you think as a policy decision it remains justified?

Ms. ROBINSON. Over the history of the Postal Service, Congress has made a number of decisions that have promoted the editorial content within magazines and newspapers. For example, the periodical prices right now for mailing editorial content are much lower than for the advertising portion of the mail. In the early to mid-1990's, a decision was made by Congress that periodicals should no longer be directly subsidized through appropriations, and that those—that product should cover its costs through the prices paid. However, the public policy goals of promoting the dissemination of information and news has been maintained through the pricing structure of periodicals.

Mr. LYNCH. OK. I understand that. What I was asking you is in light of the fact that we now have the Internet, we have radio, we

have TV that we didn't have when we adopted that policy, can it still be justified given the fact that other ratepayers, other mailers, other customers of the Postal Service are subsidizing newspapers?

Ms. ROBINSON. The role of periodicals in American society is really one that is one of disseminating information. I think there's a lot of value of that to the American people. When we survey customers, folks that receive the mail, they get a lot of value and use out of the mail from finding that periodical that they requested in their mailbox. The periodical is one of the few things that people actually pay to receive. That value in the mailbox is important for the Postal Service to keep our customers interested in valuing the mail that they receive.

Mr. LYNCH. I understand that. I guess we're not really getting at the question, though. There are a lot of good things that are out there for people that are provided by the private sector without subsidy. They actually pay for stuff, and they pay full price for that item, for that information, for the Internet, radio, TV, and—but this is a special category that we set out early on at the birth of this country that we were going to subsidize through the Postal Service, the dissemination of periodicals and newspapers, and I'm just asking you as a public policy position whether that is still justifiable given the fact that there's all kinds of other sources of information out there that are available to the public that serve this purpose and are not subsidized by the Postal Service.

Ms. ROBINSON. The Postal Service is looking at adjusting periodicals prices so they do cover their costs. We're concerned about the potential effect on the periodicals industry. We did that all in one step. At the end of the day, there is a public policy decision that is framed and discussed in the terms that Congress has established for periodicals pricing, which it does recognize in law the fact that the educational, scientific and informational value of the mail is important and needs to be considered within the prices we charge for periodicals mailing.

Mr. LYNCH. Thank you.

Mr. Waller.

Mr. WALLER. Well, it's in the law, and the Commission is focused on, you know, following the law, and considering that it's always been—those factors have been there, I think that's a policy decision that Congress needs to address more than someone like the Commission.

But in some of our hearings we have had very lively debates about this issue that you are talking about right now where the various mailers, in fact, came to—with a complaint to the Commission that the—a few years ago that the pricing of periodicals was not appropriate given all the changes that you've——

Mr. LYNCH. Look, in a perfect world I guess if we were making boatloads of money at the post office, we probably wouldn't be having this hearing, but I'm worried about the pension benefits, the health care benefits for these workers, and just trying to stabilize this system. And here is this somewhat of a luxury—I know we've always done it this way, but times have changed enormously, and the justification and the underpinnings for our policy have certainly eroded over time with the abundance of medium.

Mr. WALLER. The Commission, back the last time that we set rates before the PAEA came into effect, made some fairly dramatic increases in—or changes in the pricing structure to get what was perceived as maybe a fairer sharing of the burden of the periodicals costs among all the mailers there. It was sort of trying to address things are changing, maybe the pricing structure does need to change, and some were put into effect. They did have some negative impacts, and the Commission was criticized very heavily for some of those decisions.

So I'd say the policy reasons are very alive out there for continuing this. The American public does seem to still want the special treatment for this, at least several of the groups that participate in this industry.

Mr. LYNCH. OK. I've overstayed my time.

The chair now recognizes the gentleman from Utah, Mr. Chaffetz, for 5 minutes.

Mr. CHAFFETZ. Thank you, Mr. Chairman.

Talking about nonprofit mailers if I could for a second, very similar to what the chairman was talking about, give me a sense of the size and scope and the subsidies that really the American people are making for nonprofit mailers.

Ms. ROBINSON. Nonprofit standard mailers typically pay 60 percent of the average revenue per piece of a—a commercial mailing that would be similar. There are also discounts associated with periodicals mailed, about a 5 percent discount. So there are preferences granted by statute for that mail.

Mr. CHAFFETZ. And either of you, what is the total subsidy that's coming from the American people? And isn't there an appropriation that actually is there to cover that cost, or does that just go to the bottom line?

Mr. WALLER. That's for the blind——

Ms. ROBINSON. Yeah. The only congressional appropriations that we receive associated with providing mail is for free mail for the blind and overseas voters.

Mr. WALLER. About half of that loss in standard mail that we were talking about, standard flats, can be traced to the nonprofits.

Mr. CHAFFETZ. Dollarwise what would that be——

Mr. WALLER. Dollarwise. Dollarwise.

Mr. CHAFFETZ. What would be that dollar amount?

Mr. WALLER. About $300 and some thousand—$300 million.

Mr. CHAFFETZ. $300 million.

Mr. WALLER. I was looking for the exact number here. The loss per piece on standard mail flats that are the commercial is 4.7 cents. It's 22.4 cents for the nonprofit mail. So it's taking a big hit, and even though they're a smaller percent of the volume, it comes out almost equal, $311 million or something like that, or approximately that. We did put that number in the——

Mr. CHAFFETZ. When is the last time we did an analysis of what would happen if we, you know, got rid of the subsidy or adjusted the subsidy or however you want to frame it, but when's the last time that's been reviewed? I'm new to this so I need some help being pointed in the right direction to where specifically that is and when—when is the last time we actually revisited that particular portion of it.

Ms. ROBINSON. We did an analysis that was presented to the FTC. I believe it was 2007 or 2008. The cumulative——

Mr. CHAFFETZ. Whatever it is, could you provide that to us?

Ms. ROBINSON. We can provide that for the record.

Mr. CHAFFETZ. I know it is hard right off the top of your head. And it actually kind of scares me that you actually know that right off the top of your head.

Ms. ROBINSON. Yeah. Basically the cumulative value of the nonprofit mail subsidies and the periodicals together was about $1½ billion.

Mr. CHAFFETZ. OK. And of that, the nonprofit was—OK.

Ms. ROBINSON. I believe it was about half and half, so I don't remember the exact numbers.

Mr. WALLER. I was talk talking about the flats. It was $311 million.

Mr. CHAFFETZ. OK. A significant enough number that I would, Mr. Chairman, urge that we revisit and think that through as well, because it is a huge, huge number. And there are many tax benefits that are offered for being a nonprofit, but the American people have to subsidize that. However you want to frame that, I think it is worthy of diving into and rediscussing at some point.

I yield back. I know we've got another panel that's waiting, so thank you for the additional time.

Mr. LYNCH. I thank the gentleman and I welcome his questions. And I agree there are nonprofits and there are nonprofits. And maybe we should look and see the amount of benefit that is actually derived to the public for each and every one.

Let me ask in closing, I know we talked about this exigent rate case that's coming up in 2011, do we have a timeframe on that? And when should we—I know you've got a delicate balance here because of the potential shock value or shock impact of that rating decision on a very fragile system here. So do you have at least a timeframe in mind?

Ms. ROBINSON. Yeah, we would be looking at changing prices to the exigent mechanism early in 2011. Under the statute, the Commission has 90 days to evaluate our request once that's filed. And we intend to leave an appropriate amount of time for our customers to actually implement that change. So we're looking at about 6 months lead time.

Mr. LYNCH. OK, thank you.

Mr. WALLER. And the Commission is committed to getting that in 90 days, as required.

Mr. LYNCH. OK, well, that's great. I want to thank you both. I think you've suffered enough. Ms. Robinson, Mr. Waller, thank you for your testimony, for helping the committee with its work. Have a good day.

Could we ask the second panel to take their seats? Thank you.

Thank you and welcome to our second panel. Before we move to questioning, as you know, the custom for this committee is to have all witnesses sworn who are about to offer testimony. May I please ask you all to rise and raise your right hands?

[Witnesses sworn.]

Mr. LYNCH. Let the record show that each of the witnesses has responded in the affirmative. I will now offer a brief introduction of each of our panelists on our second panel.

Mr. William Burrus, is president of the American Postal Workers Union. Mr. Burrus is also a member of the executive committee of the Union Network International, a global federation of unions that represent postal and other service workers.

Mr. Lawrence Buc is the president of SLS Consulting, Inc. SLS is a Washington, DC, Consulting firm that specializes in postal economics and environmental analysis. Mr. Buc participated in rate classification and complaint cases regarding the Postal Service for 35 years.

Dr. Richard Riley, is a professional—excuse me—is a professor in the MBA and executive programs at the University of Maryland University college where he teaches finance, economics and accounting to MBA candidates and executive MBA candidates. Previously Dr. Riley served as chief financial officer of the U.S. Postal Service from 1993 to 1998.

Mr. James O'Brien, is vice president of distribution and postal affairs at Time Inc. and has been with Time since 1978. He is currently the chairman of Mailers Council and a member of the Magazine Publishers of America, Government Affairs, and Postal Committees.

Hamilton Davison has been executive director of American Catalog Mailers Association since its founding in April 2007. Mr. Davison's involvement in postal affairs began in 1992 with his service on the Greeting Card Association Postal Affairs Committee. Welcome all.

As you know, each of you will be given 5 minutes for an opening statement. The lights will indicate green at the beginning, yellow as you proceed, as you're getting toward the end, and then red when you should wrap up.

President Burrus, you're recognized for 5 minutes for an opening statement.

STATEMENTS OF WILLIAM BURRUS, PRESIDENT, AMERICAN POSTAL WORKERS UNION, AFL–CIO; LAWRENCE G. BUC, PRESIDENT, SLS CONSULTING, INC.; MICHAEL RILEY, PROFESSOR, UNIVERSITY OF MARYLAND UNIVERSITY COLLEGE; JAMES R. O'BRIEN, VICE PRESIDENT FOR DISTRIBUTION AND POSTAL AFFAIRS, TIME INC.; AND HAMILTON DAVISON, EXECUTIVE DIRECTOR, AMERICAN CATALOG MAILERS ASSOCIATION

STATEMENT OF WILLIAM BURRUS

Mr. BURRUS. Thank you Mr. Chairman, Chairman Lynch, Ranking Member Chaffetz and members of the subcommittee. Thank you for providing the opportunity to testify on behalf of the more than 250,000 members that we are privileged to represent. We are proud to work for the Postal Service, the largest and most efficient postal system in the world.

I ask my written remarks be entered into the record, please.

Mr. LYNCH. Without objection.

Mr. BURRUS. I begin by thanking you for scheduling a hearing on the subject, Workshare Discounts. This is a topic of great interest to our union and we appreciate the opportunity to share our views. The law that requires the Postal Service to provide universal service at uniform rates is absolute. There are no exceptions for large or small mailers or for great or short distances between senders and receivers. This universal service obligation justifies the Postal Service monopoly and restricts competitors who would attempt to skim the profitable segments while leaving the poor, the handicapped, and those living in rural communities to fend for themselves.

Unfortunately, the Postal Service in concert with major mailers has implemented discounts that violate the standard of universal service at uniform rates. This is not only illegal, it is also self-defeating, depriving the Postal Service of the revenue to maintain the Nation's mail network.

Workshare discounts were introduced in the 1970's, but as early as 1990 the Postal Service acknowledged that the relative value of presort is declining. Today workshare discounts artificially reduce the mailing costs of favored customers at the expense of individual citizens' small businesses.

The law stipulates that workshare discounts may not exceed postal costs avoided. However, the PRC has repeatedly found the discounts exceed this standard. Most recently, they found that 30 types of workshare discounts exceeded the postal cost avoided. When discounts exceed the standard, the result is that individuals in small businesses contribute a larger share of the institutional cost, and, contrary to sound economic principles, as postal efficiency has increased, workshare discounts have also increased from 7.6 percent of the postage rate in 1976 to 23.9 percent in 2009. This is a Ponzi-like scheme that Bernie Madoff would be proud of.

The Postal Service begins with a monopoly power to set rates, then diverts volume, resulting in a self-induced exaggeration per-piece cost to set the discounts. At the same time, discount-funded private mail processing plants are open, while more efficient postal processing centers are consolidated. The results benefit major mailers, while making the Postal Service less efficient and more expensive.

In response to reduced mail volume and the crushing burden of prefunding future retiree health care liabilities, some have opined that postal workers must make wage and benefit concessions to fund this transfer of revenue and productivity.

For the record, I have challenged the Post Master General to set employee compensation at a rate that is lower than the discounts offered to major mailers. Simply put, pay postal employees at the cost of the awarded rate. He has not responded to date, and I don't expect him to.

APW has long asserted that postage discounts in their current form are indefensible and illegal. So now the Postal Service and major mailers are attempting to change the standards, and we urge Congress to reject any such change.

Regarding the excessive workshare discounts, the burning question is, why? Why would the Postal Service forego billions of dollars per year in revenues, particularly when they are projecting a $7

billion loss? When it is suffering from reduced volume, the unachieved payment schedule for future health-care liabilities, and the cultural shift in communications I ask, why? One anticipated answer is volume. However, history shows that rate increases equal to or below the rate of inflation have only a marginal effect on volume. The record shows that volume has declined by more than 30 percent at a time when postage rates, when adjusted for inflation, are at their lowest level in 50 years. A graph attached to my testimony shows that even as discounts have increased, volume has declined.

Workshare discounts and other give-away programs have peaked at the same time that mail volume has plummeted. If rates indeed drive volume, we would expect the opposite to be true. So given the data, why would the Postal Service set discounts above the legal standard?

A defense that cries out for review is the assumption that if not for the illegal rates, volume would have declined even further. Such a defense shifts the burden of proof to the unknown, the impossible to prove, and evades the requirement of the law.

The American public is entitled to know why the cost avoided and uniform rate standards have been breached. I respectfully ask that Congress provide the answer.

Thank you for the opportunity to testify and I will be pleased to answer any questions you may have.

Mr. LYNCH. Thank you, sir.

[The prepared statement of Mr. Burrus follows:]

APWU CONGRESSIONAL TESTIMONY

American Postal Workers Union, AFL-CIO

WILLIAM BURRUS
PRESIDENT

Before The

FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA

SUBCOMMITTEE

U.S. HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

"The Price is Right, or is it? An Examination of USPS Workshare Discounts and Products that Do Not Cover Their Costs"

TESTIMONY OF WILLIAM BURRUS, PRESIDENT
AMERICAN POSTAL WORKERS UNION, AFL-CIO

May 12, 2010

1300 L Street, NW
Washington, DC 20005
-842-4250
Fax 202-842-4297
www.apwu.org

Chairman Lynch, Ranking Member Chaffetz, and Members of the Subcommittee: Thank you for providing the American Postal Workers Union the opportunity to testify on behalf of the more than 250,000 members that we are privileged to represent. We are proud to work for the U.S. Postal Service, the largest and most efficient postal system in the world.

I want to begin by thanking you for scheduling a hearing on the subject of workshare postage discounts. This is a topic of great and historic interest to our union, and we appreciate the opportunity to share our views. If my predecessor, Moe Biller, is watching us from above, I am sure he is pleased that the egregious abuses of workshare discounts have finally been deemed important enough to warrant congressional attention.

The law that requires the Postal Service to provide universal service at uniform rates is absolute: There are no exceptions for large or small mailers, or for great or short distances between senders and receivers.[1] The USPS must provide mail services to all Americans – rich and poor, urban and rural, young and old, able-bodied and handicapped – at a uniform price.

The universal service obligation justifies the Postal Service's monopoly, and restricts competitors who otherwise would attempt to skim the profitable segments of our nation's mail system, while leaving the disadvantaged, the physically challenged, and those living in outlying communities to fend for themselves.

Unfortunately, the Postal Service, encouraged by major mailers, has implemented discounts that violate the standard of universal service at uniform rates. This is not only illegal, it is also self-defeating: It deprives the USPS of revenue that is essential to maintain the nation's mail network.

Workshare discounts were introduced in the early 1970s, when most mail was sorted manually, as a way to ease the transition to mechanized sortation and eventually to automated mail processing.[2]

With the transition to automated mail processing essentially complete, workshare discounts have become unnecessary. In fact, as early as 1990, the USPS acknowledged that the "relative value of presort is declining."[3]

Today, workshare discounts artificially reduce the mailing costs of favored customers – large mailers – at the expense of individual citizens and small businesses. Simply stated, the Postal Service has established different rates for letters originating from the same city, bearing the same barcodes, and going to the same destination.

---

[1] 39 U.S.C. § 404(c) provides, in part: "**(c)** The Postal Service shall maintain one or more classes of mail for the transmission of letters sealed against inspection. The rate for each such class shall be uniform throughout the United States, its territories, and possessions..."

[2] In its 1980 Annual Report (p. 6), the Postal Service stated that in "the past several years, we have depended on presort programs to bridge the gap between the mechanization we now have and the automation we plan."

[3] Direct Testimony of Ashley Lyons in R90-1 before the PRC, p. 107.

Attachment A to my testimony serves as a vivid example. I urge you to review it and see if you can find disparities that justify the different rates indicated on the envelopes. Both letters (mailed in 2009) display nine-digit barcodes and are machine-readable on postal equipment. Despite the similarity in the preparation of the mail, one customer paid 42 cents for first-class delivery, while the other paid just 34 cents.

For more than a decade, the American Postal Workers Union has criticized these exceptions to the universal-service at uniform-rate requirements. In contentious debate, we have attempted to expose the illegality of excessive rate discounts, and the detrimental effect they have on the Postal Service.

When Congress enacted the Postal Accountability and Enhancement Act (PAEA), it stipulated that workshare discounts may not exceed "postal costs avoided."[4] However, the standard has been manipulated to such an extent that the Postal Regulatory Commission (PRC) has repeatedly found that discounts exceed the costs-avoided standard. Most recently, on March 29, 2010, the commission found that ***30 types*** of worksharing discounts exceed this standard.

"Postal costs avoided" and the appropriate methodology for determining them are discussed in detail in Comments filed by the APWU in a case pending before the Postal Regulatory Commission.[5] A copy of those Comments is Appendix A to this testimony.

Revenue to pay for the "institutional costs" of the postal system is generated from various classes of mail, with First Class single pieces contributing a disproportional share. When this mail is segmented into discounted and non-discounted mail, the contribution to institutional costs is significantly reduced, with workshared mail making a minimal contribution. When discounts exceed the postal costs avoided, the result is that individuals and small businesses who pay the unreduced rate contribute a larger share of the institutional cost. This shifting of postal work from the public to private sector through excessive workshare discounts is inefficient and violates sound economic policy for the mailing industry.

Management has invested a kingly sum – more than $50 billion – in automation, computerization, facility redesign, and enhanced encoding capabilities, and the size of the workforce has been reduced substantially. As a result, the Postal Service has become more efficient and the relative cost of mail processing has declined significantly. However, contrary to sound economic principles, as postal efficiency has increased, workshare discounts also have increased, from 7.6 percent of the postage rate in 1976 to 23.9 percent in 2009. These increases simply cannot be justified.

A Nov. 20, 2009, USPS presentation demonstrates that workshare discounts are excessive: In a report promoting a "new business model," the Postal Service proudly

---

[4] 39 U.S.C. § 3622(e).

[5] Comments of American Postal Workers Union, AFL-CIO, (Sept. 11, 2009, PRC Docket No. RM2009-3.

announced the low cost of processing automated letters: just $6.17 per 1,000 pieces.[6] In other words, it costs the Postal Service six tenths of one cent to sort and process each automated letter, but the USPS deducts 10.5 cents per letter from the price of a stamp for major mailers who print a bar-code and pre-sort their letters to the 5-digit zip code. Discounts of this size are in blatant violation of the law.

However, as the Postal Service confronts reduced mail volume and the crushing burden of pre-funding future retiree healthcare liabilities (imposed by Congress in Postal Accountability and Enhancement Act of 2006), some have opined that postal workers governed by collective bargaining agreements must make wage- and benefit concessions to help the USPS address its financial difficulties.

As a matter of principle, I refer subjects more appropriately addressed at the bargaining table to the proper forum. However, I want to share with the subcommittee that I have issued a challenge to the Postmaster General: I have invited him to set employee compensation at a rate that is lower than the discounts offered to major mailers, which is allegedly based on the "postal costs avoided."

If rates can be reduced in the amount of 10.5 cents per letter for affixing five-digit barcodes, let postal employees perform that work, and we will guarantee reduced costs. I even volunteered that our members would process parcels for free! The postmaster general has not responded to my challenge, and I do not expect him to reply in the future. Using any standard, the five-digit barcode discount of 10.5 cents per letter far exceeds the postal costs under existing labor contracts.

In recent years, the APWU has appealed to many agencies – including Congress, the Office of the Inspector General, the courts, the Postal Regulatory Commission, and any other entity that would grant us audience – asserting that postage discounts in their current form are indefensible and patently illegal.

So now the Postal Service and major mailers are attempting to change the rules. They seek to change the standard – so that the indefensible rates can be justified. We urge Congress to reject any such change.

Regarding the excessive workshare discounts, the burning question is, **"Why?"** Why are rates for some customers arbitrarily discounted in violation of the universal standard?

Why would the Postal Service forego billions of dollars per year in revenue from its largest mailers when it is suffering from reduced volume, the unachievable payment schedule for future healthcare liabilities, and the cultural shift in communication? Postal data is highly computerized, so management knows the cost of every function involved in mail service. The veil of secrecy must be lifted. How can the Postal Service justify manipulating uniform rates so that postage for a letter sent by a large mailer can be as

[6] Presentation by Mary Ann Gibbons and Linda A. Kingsley entitled "A New Business Model for the United States Postal Service," at 5.

low as 19 cents, while an identical letter sent by an individual or small business costs 44 cents?[7]

One anticipated answer to this perplexing question is "volume" – the Postal Service's belief that discounts spur increases in mail volume. However, history shows that rate increases equal to or below the rate of inflation have only a marginal effect on volume. The record shows that volume has declined by more than 30 percent at a time when postage rates, when adjusted for inflation, are at their lowest level in 50 years. Graph A shows that even as discounts increased, volume followed the downward trend. Despite assertions by the USPS and major mailers, postage discounts don't increase mail volume.

The use of workshare discounts, drop shipments, summer sales, Negotiated Service Agreements and other give-away programs have peaked at the same time that mail volume has plummeted. If rates indeed drive volume, we would expect the opposite to be true. So, given the historic data, if reduced rates do not increase volume, why would the Postal Service violate the law and set discounts above the legal standard?

A defense that cries out for review is the assumption that if not for the illegal rates, volume would have declined even further – the suggestion that "things would have been worse." Such a defense shifts the burden of proof to the unknown, and evades the requirement of the law. There are no exceptions in current law, so the only alternatives are to "change the law or comply."

The American Postal Workers Union will continue to urge Congress to enforce strict compliance with the cost-avoided standard, but we suggest that you take the next step and attempt to uncover the motivation for the deliberate misapplication of the uniform rate standard. Such an investigation is within the province of the Office of Inspector General, but the OIG has ignored clear evidence over a period of 10 years or more. The OIG has abdicated any responsibility to eliminate these illegal subsidies, and cannot be relied upon to reveal the underlying reason for this statutory violation.

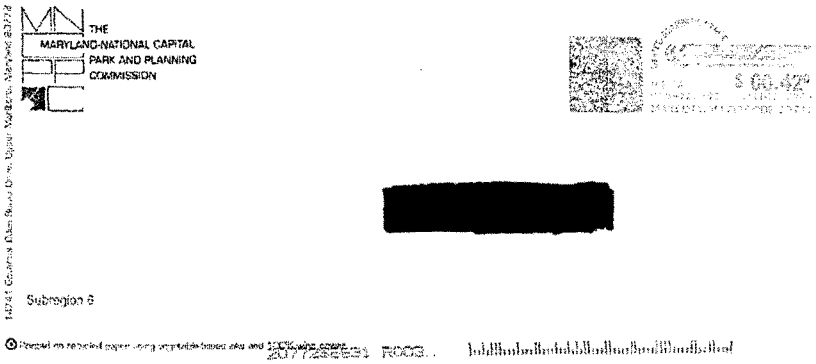
We turn to Congress and this Subcommittee and encourage you to require a full accounting of the reasons for the clear violations of the uniform-rate standard. It is well past the time to debate whether workshare discounts comply with existing law: Clearly, they don't. The American public is entitled to know why this standard has been breached, and I respectfully ask that Congress provide the answers.

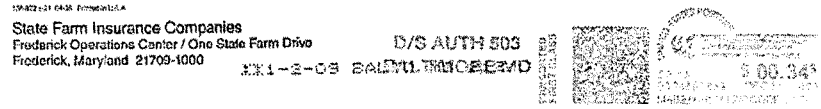
Thank you for the opportunity to testify. I would be pleased to answer any questions you may have.

---

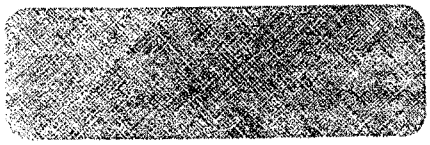
[7] Mailers pay 19 cents each for standard letters weighing up to 3.3 ounces when they are entered at the SCF where the mail will be delivered, provided the letters are in trays and sorted to the five-digit zip code.

Attachment A





IMPORTANT



APPENDIX A:

Comments of American Postal Workers Union, AFL-CIO
September 11, 2009

Before The Postal Regulatory Commission

"Consideration of Workshare Discount Methodologies"

Postal Regulatory Commission
Submitted 9/11/2009 4:29:42 PM
Filing ID: 64715
Accepted 9/11/2009

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

Consideration of Workshare Discount Methodologies **Docket No. RM2009-3**

COMMENTS OF
AMERICAN POSTAL WORKERS UNION, AFL-CIO
(September 11, 2009)

The American Postal Workers Union, AFL-CI0 (APWU) hereby submits these comments in response to the Commission's July 10, 2009, Order on Further Procedural Steps, Order No. 243. The rulemaking came about as a result of Docket No. R2009-2, wherein the Postal Service proposed workshare discounts that were "not based on established workshare cost avoidance methodologies."[1] The Postal Service unsuccessfully sought to abandon these principles in the past.[2] For the reasons explained more fully below, the Commission should reject proposals by the Postal Service and other participants that would undermine the statutory requirement that workshare discounts not exceed costs avoided by the Postal Service.

The PAEA Requires that the Rates for First-Class Single Piece and Presorted Mail Remain Linked by a Benchmark.

Section 3622(e) of the Postal Accountability and Enhancement Act (PAEA) defines workshare discounts as "rate discounts provided to mailers for the presorting, prebarcoding, handling, or transportation of mail, as further defined by the Postal Regulatory Commission."[3] The Act further mandates: "[t]he Postal Regulatory Commission shall ensure that such discounts do not exceed the cost that the Postal Service avoids as a result of the workshare activity."[4]

---

[1] PRC Order No. 192, March 16, 2009.
[2] See Docket No. R2006-1 and Docket No. R2008-1.
[3] 39 U.S.C. § 3622(e)(1).
[4] Id. at §3622(e)(2).

The Senate Report by the Committee on Governmental Affairs that accompanied the workshare provision clearly endorses this concept of workshare discounts:

> The Committee agrees with the principle, supported by the Postal Service, the Postal Rate Commission, and postal employees, that workshare discounts should generally not exceed the costs that the Postal Service avoids as a result of the worksharing activity. When discounts are kept below the costs saved by the Postal Service, mailers have a financial incentive to do work more efficiently than the Postal Service can do it, yielding savings to the participating mailers, to the Postal Service, and to other postal customers whose rates are kept down by the Postal Service's savings under the program.[5]

The Report also shows that Congress adopted the Commission's previously delineated exceptions to this general rule:

> There are four circumstances under which workshare discounts in excess of avoided costs have historically been allowed by the Postal Rate Commission and are warranted, and the Committee has codified these exceptions in the legislation:
>
> The first exception applies when a discount is associated with a new or changed postal product... .
>
> The second exception provides that a workshare discount may exceed costs avoided if a reduction in the discount would – (i) lead to a loss in volume of the affected category of mail and thereby reduce the aggregate contribution to institutional costs, (ii) result in a further increase in rates paid by mailers not able to take advantage of the discount, or (iii) impede the efficient operation of the Postal Service.
>
> The third exception allows a workshare discount to exceed costs avoided if that excess portion of the discount is necessary to mitigate rate shock and will be phased out over time... .
>
> The fourth exception applies to discounts that are provided in connection with subclasses of mail consisting exclusively of material having educational, cultural, or scientific value.[6]

The only way to ensure that discounts do not exceed costs avoided is to compare the workshare piece to a benchmark that differs from the workshared mail only because of a lack of workshare activities. To de-link workshared first class mail from single piece first class mail, to refuse an across-product comparison would completely ignore this requirement of 3622(e) and the protections offered by it to single-piece users.

---

[5] Sec. Rpt. 108-318, at 12 (Jul. 22, 2004). While this Report is from the 108th Congress, this was the genesis of the workshare language adopted.
[6] Id.

As the Commission observed in MC95-1, ¶ 2048, "...the first and most enduring objective of postal policy has been to bind the nation together." The Postal Accountability and Enhancement Act amended many areas of the Postal Reorganization Act, yet this principle remains a constant, central objective of postal policy. Section 404(c) of the Postal Reorganization Act provides, in part:

> The Postal Service shall maintain one or more classes of mail for the transmission of letters sealed against inspection. The rate for each such class shall be uniform throughout the United States, its territories, and possessions.

The Commission observes that "[a] class such as First Class is necessary to comply with the statutory command [of Section 404(c)] that ...[t]he rate for [First Class] shall be uniform throughout the United States, its territories, and possessions." Id., at ¶ 3005.[7] Consistent with this requirement, the Commission consistently adhered to the principle that workshare discounts may not exceed costs avoided. Mr. Taufique, the Postal Service's First Class rate design witness in R2006-1, describes this concept in his testimony.

> Since classification reform in Docket No. MC95-1, the structure of and approach to the relationship between the Single-Piece and Workshare rate categories in First-Class Mail have remained relatively constant. Workshare rates are determined by applying discounts to Single-Piece rates. These rate differentials (discounts) are based on estimates of costs avoided through each type of worksharing activity (e.g. prebarcoding and/or various levels of presortation). The cost differentials are developed by estimating avoidance of postal mail processing and related operations costs in comparison to a representative benchmark for workshare mail generally. [8]

Those that are participating in worksharing are compensated only for the costs avoided by the Postal Service and the non-worksharing mailers are no worse off. Thus, the application of the cost avoided standard for workshare discounts is necessary for compliance with the statutory requirement of a uniform First Class rate. If discounts exceed the costs avoided by the Postal Service, costs will shift to non-workshare mailers and rates will not be uniform.

In Docket No. R2006-1 the Commission reasoned that "[d]elinking the rate design [between First Class single piece and presort mail] does not fairly and equitably balance

---

[7] The requirement was then in 39 U.S.C. 3623(d).
[8] R2006-1,USPS T-32, p. 12.

the interests of all First-Class mailers." PRC Op. R2006-1 at ¶ 5090. The Commission noted that abandoning the benchmark and de-linking single piece and presort mail "allows many costs that are not worksharing related to be avoided" by presort mailers. The enactment of the PAEA did not change this fact. The legislative underpinnings for requiring a uniform rate for First Class mail have not been amended by the PAEA. The central postal policy has been and remains to "bind the Nation together."[9] Section 404(c) is unaltered; thus, the requirement for a uniform rate for First Class remains unchanged. To now treat single-piece mail and presort mail as separate, un-linked products would contravene the decision of Congress to continue these enduring postal policies by codifying the principle that workshare discounts not exceed costs avoided.

During the Public Forum, held on August 11, 2009, it was suggested that single piece users may find protection in other areas of the PAEA, namely the objective that rates be "just and reasonable."[10] While it is true that this provision affords some protection to single piece users, there are practical problems to enforcing this provision. The streamlined rate setting procedure makes it difficult to enforce as it would only be evaluated if 1) a complaint were filed or 2) during the Commission's Annual Compliance review, usually close to a year after the rates have taken effect.

The new complaint system is mostly untried,[11] and it is not clear who would bring a complaint on behalf of single-piece mailers. It is possible that a Public Advocate could represent the interests of single-piece mailers, but Public Representatives are appointed by the Commission **after** a proceeding has been initiated and the Commission has placed it on the docket. There is no incumbent Public Representative to initiate a proceeding whenever it feels as though a rate schedule is not "just and reasonable." Even if such a complaint were contemplated by a Public Representative or an individual citizen, the just and reasonable standard is too amorphous to be an adequate proxy for legal restrictions on excessive discounts. Furthermore, establishing a violation of an undefined "just and reasonable" standard would likely prove extremely costly, more than likely prohibitively so for the majority of single piece mailers most affected by unjust rates.

---

[9] 39 U.S.C. § 101(a).
[10] *See* 39 U.S.C. § 3622(b)(8).
[11] To date, only one Complaint docket has been established under the new complaint rules, C2009-1.

The Annual Compliance Review also does not provide an adequate means of enforcing the "just and reasonable" requirement to protect single piece mailers. From the Annual Compliance Determinations issued thus far, it does not appear that the Commission considers and evaluates all of the factors and objectives of the Act. Also, the annual compliance occurs at the end of the calendar year, usually long after rates have been in effect. The Commission must issue its Report within 90 days of receiving the Postal Service's annual report. There is little opportunity for public participation or comment during this time. This is especially problematic since the Commission has decided

> A written determination finding no instance of noncompliance creates a rebuttable presumption of compliance with the matters regarding rates and fees and service standards in effect during such year in any complaint proceedings filed pursuant to § 3662 of the PAEA. 39 U.S.C. § 3653(e).[12]

The workshare discount language provides a valuable protection for single piece users against impermissible cost shifting. No other protection can sufficiently replace that afforded by the workshare language.

Section 3652(b) Creates No Impediment to Keeping First-Class Single Piece and Presorted Mail Linked.

Section 3652(b) requires that workshare discount information be reported "with respect to each market-dominant product for which a workshare discount was in effect." This requirement is entirely consistent with Section 3622(e). A product can serve as the smallest unit of a rate category. Requiring workshare information to that level ensures that all of the discounts within the class are based on costs avoided. Thus, the reporting mandates help ensure compliance with 3622(e). The contrary interpretation offered by the Postal Service and supported by some others, is not suggested, much less required by the statutory language. Moreover, it would nullify the protections of the workshare language so recently adopted by Congress.

In statutory construction, "[i]t is well established that [Courts] will not assume Congress intended an odd or absurd result. *Rucker v. Davis* 237 F.3d 1113, 1124 (C.A.9 (Cal.),2001) *citing X-Citement Video,* 513 U.S. at 69-70, 115 S.Ct. 464; *Public Citizen,*491

[12] PRC Annual Compliance Determination Report 2007 at p. 5, March 27, 2009.

U.S. at 453-55, 109 S.Ct. 2558. As the Greeting Card Association has observed, the Postal Service's interpretation could lead to the absurd situation where "the rate difference between [a workshared version of an otherwise identical non-presorted product] would not be a workshare discount even though, apart from the worksharing involved, there would be no reason for it to exist."[13] To endorse the Postal Service interpretation would read out the workshare language almost entirely from the statute; a result that must not be permitted.

Bulk Metered Mail is Still the Proper Benchmark and Must Be Used to Determine Costs Avoided

There are two purposes for using a consistent benchmark piece in discount calculations. The Commission, in its R2000-1 Opinion confirming the use of BMM letters as the appropriate benchmark [at 5089], stated the primary reason for using the benchmark:

> This may mean that the institutional cost burden of First-Class workshare mail is increasing. However, when discounts pass through 100 percent of avoided costs to the workshare mailer, the contribution made by that mailer to institutional costs is the same as the mailer would have made without worksharing. Thus, workshare mailers and non-workshare mailers provide the same contribution, which is fair and equitable. [14]

The comparison is not between the workshared mailer and all the single-piece mailers. The comparison has always been to what the presort mailer would pay if that mailer was not worksharing. That comparison is what isolates the worksharing contribution to cost savings. This echoes the comments in the original MC95-1 case where the Commission stated

> the most important reason for using a discount approach to recognize cost distinctions brought about by worksharing is that the Commission has determined that this is most fair and equitable to all mailers. Worksharing mailers receive a price reduction based on avoided costs while residual mailers are no worse off.[15]

---

[13] GCA Reply Comments, at p.7, August 31, 2009.
[14] *Opinion and Recommended Decision* R2000-1, at 5060, page 234 and 5089 at p. 241.
[15] *Opinion and Recommended Decision MC95-1*, at 3079, page III-31.

In discussing its decision to use a benchmark, in R97-1, the PRC quoted Postal Service witness Fronk's testimony:

> [n]onpresorted mail includes everything from 'clean' mail (uniform pieces featuring typewritten or pre-printed addresses and often mailed in bulk) to 'dirty' mail (pieces featuring handwritten and incorrect or incomplete addresses) and all the mail in between. Using all nonpresort letters as a benchmark results in a larger discount than using a benchmark which tends to have all the attributes of presort/automated mail, except for the actual presortation or application of the barcode.[16]

In its R2006-1 Decision, the Commission identified other major reason for using such a benchmark when it stated a "comparison of pieces that are similar, except for worksharing, is the approach most likely to accurately isolate the savings due to worksharing, and therefore allow for the development of discounts that encourage efficient mailer behavior and minimize costs to society."[17]

In order to encourage the most efficient mailer behavior it is necessary that the benchmark used remain constant. Utilizing the same benchmark enables the Postal Service, and mailers to more readily determine the costs avoided and the resulting discounts. This is useful for mailers who intend to make large capital investments in support of workshare activities it intends to perform. If the benchmark were not constant, it would be hard for mailers to accurately predict what the return on any such investment would be year to year. A consistent benchmark easily provides mailers and the Postal Service with critical information that affects the amount of workshare activity performed. If the work can be done more cheaply by the mailer than by the Postal Service, then make the investment and do the work; if not, it is better for society as a whole for the work to be done by the Postal Service.

Opponents of the BMM benchmark err in contending that BMM does not exist. In R2006-1 when asked if the BMM benchmark should continue to be used if the Commission rejected the proposal to de-link First Class single-piece and presort mail Postal Service Witness Abdirahman stated:

> Yes, that's why I explained my testimony; that the BMM is still there; and I, myself, observed their existence. And if the Commission decides not to accept the de-

[16] *Opinion and Recommended Decision* R97-1, p.292 at 5092.
[17] *Opinion and Recommended Decision, R2006-1,* February 26, 2007 at 5089.

> linking proposal, the only alternative that I see is the BMM, and that's as a costing witness.[18]

The BMM benchmark has never been precisely measured with a separate CRA cost analysis. A proxy for BMM costs has always been estimated from the CRA for metered mail letters. Consequently, the cost basis from which the BMM benchmark has always been measured is available and will continue to be available.

The benchmark piece is still important in keeping costs from being shifted from workshare mailers to those that do not participate in worksharing. Any change in the benchmark piece towards an alternative that would provide a larger avoided cost calculation, causes leakage in the system, compensating presort mailers for something they were already doing without benefit of a discount. The resulting loss of network contribution from presort mailers would shift that contribution burden to other mailers not in a position to use workshare discounts. This means that even within the price cap system imposed by the PAEA costs can be shifted to others in the same class or even to mail in different classes. The price cap limits how much a class can be increased overall and therefore how much cost shifting could be done at one time. But, a price cap does not control price increases relative to other classes or to other products within the same class.

The more productive the Postal Service becomes, the more likely it is that discounts based on avoided costs will stay constant or grow very slowly. That is exactly how the efficient component pricing system is designed to work. It only gives mailers the incentive to do the work if they can be more efficient about doing it. It clearly is not efficient to have multiple delivery networks. If the mail is to be combined into a single delivery network, all of it must eventually pass through the Postal Service's processing system to be prepared for that delivery. If the definition of the benchmark piece is changed, or worse is changed on a regular basis, then there will 1) be leakage from the system that covers the joint overhead costs of running the network and 2) a change to both the incentives the mailers are using to make their decisions and also a change in the basis for the Postal Service's return on its investments. Ultimately, the mail must come back together into one processing stream before it can be delivered by the single delivery

[18] R2006-1 Tr. 35/11968-9; see also 12050-51.

system, consequently there must be enough mail left in the system to provide a reasonable return on the investments it has made.

If, as many have observed, worksharing is now a mature industry with little single-piece mail still a candidate for conversion to presort mail, then there is limited rationale for providing mailers with incentives for trying to convert an increasing volume of mail. The universal Postal network that allows everyone to reach out to every other user in the United States is a valuable public service and also a valuable marketing tool. It is valuable to single piece users and it is valuable to business mailers who use it to contact virtually every household and business in the United States at some time during the year. There is no reason why mailers should not make as large a contribution to the support of the network as they would if they were mailing at single piece rates.

Creating A Separate Class Of First Class Single Piece Mail Will Not Provide Adequate Protection For Single Piece Mailers.

It has been proposed by the Public Representative that a new class of mail, "comprised of single-piece First Class Mail letters (and cards) be established as an "alternative to the Postal Service's efforts to abandon the BMM benchmark."[19] (PComments page 23). This proposal is clearly impermissible under the PAEA and should be rejected by the Commission.

The PAEA established an "annual limitation the percentage changes in rates...equal to the change in the Consumer Price Index for All Urban Consumers...."[20] The Act goes on to state "...the annual limitations under paragraph (1)(A) shall apply to a class of mail, **as defined in the Domestic Mail Classification Schedule as in effect on the date of enactment of the Postal Accountability and Enhancement Act.**"[21] The DMCS does not include a definition of "class of mail." Instead, it includes a listing of the classes of mail. Therefore, this provision clearly requires the cap to be applied to a class of mail as it existed on December 18, 2006. In the case of First Class Mail, the annual limitation applies to single-piece AND workshared mail.

---

[19] RM2009-3 Public Representative Comments, at p. 23, May 26, 2009.
[20] Section 3622(d)(1)(A).
[21] Id. [emphasis added].

The use of a separate class of mail for single piece users has been suggested as a potential protection for them. While being in its own class could provide some protection, it would not result in the same outcome as the current system that keeps the two rates tied together in the same class. The costs to support the shared network cannot be allocated directly to one class of mail and are shared by all the classes. Under a system in which single piece and presort mail are separated into two different classes, there could still be shifting of the costs to support that system from the presort mail to single piece. While both of the new classes could be protected in the sense that their rates could not be increased beyond the rate of inflation, the single piece "class" could well be faced with price increases that are always at the maximum end of the rate cap while the presort mailer is given further discounts or other rate cuts that reduce the contribution they make to sustain the Postal network. In this manner costs would be shifted from the presort mailer to the single piece mailer. The current system puts a fair and equitable cap on how much of a shift can take place since the workshare discounts can not exceed the costs avoided by the Postal Service. What has not been addressed in the rather vague discussions of separate classes is the wide variety of mail that would still remain in First Class single piece mail. It would still be non-homogeneous and run the gamut from hand-addressed birthday cards to type-written business letters and would include everything from consumer reply mail to netflix. Inevitably, the long term rate increases for single piece mail would outpace the rates for workshared mail.

The other danger to a separate class is that it would also leave open the option for there to be different service provided to those two classes. If the contribution to the network provided by presort mailers is decreased, as is certain to happen if the class is separated and/or the rates de-linked, single-piece users will either face an increase in rates or a decrease in service. Either result is clearly prohibited by the PAEA and the requirement there be a uniform rate and service for First Class mail. Therefore, separating the First Class offers little protection to first class single piece users and would lead to results that violate the law.

Postal Service Flexibility

We observe that the Postal Service argument for de-linking boils down to a complaint that the CPI limitation on rate increases and the requirement that workshare discounts must not exceed costs avoided have, in combination, left the Postal Service with too little rate-making flexibility. We have several responses to that complaint. One is that Congress made the policy decisions that underlie the CPI cap and the restriction on workshare discounts; and Congress spelled out the CPI and worksharing standards in the statute. There is no doubt that Congress was aware of the hybrid nature of the system -- that it employs both a rate cap and cost-based standards for rates. Both requirements are written in clear statutory terms. To the extent that there is any tension between the two statutory requirements, and we think the Postal Service overstates that tension, the Postal Service is nevertheless required to comply with both provisions of the law.

It is important to observe that Congress, in codifying the Commission's prior decisions on workshare discounts, included in that codification as temporary exceptions several circumstances the Commission had recognized in its decisions as justifications for flexibility in the application of the costs avoided standard.[22]

Finally, we observe that the tension in First Class rates is created not so much by the combination of the CPI cap and workshare discount restrictions as by the tension between whole integer rate increases and the CPI cap. CPI cap banking is one way for any resulting rate-making inefficiency to be resolved over the long run. There also are several other rate-making tactics that have been suggested elsewhere that would address these circumstances without violating the law. Whether the Postal Service or the Commission will seek to adopt those strategies is a topic for a different proceeding.

[22] *See supra* p. 2.

Conclusion

For the reasons explained above, the Commission should maintain the link between First Class single piece and presort mail. The Postal Service interpretation of the workshare requirement and its assertion that the workshare discount limitation should not be applied across products undermines the statutory requirement that workshare discounts not exceed the costs avoided and should be rejected. In order to effectuate all provisions of the Postal Accountability and Enhancement Act, and to ensure the continued protection of single-piece users against unjust cost shifting, the Commission must ensure the workshare discounts do not exceed costs avoided. The only way to keep workshare discounts from exceeding costs avoided is through the use of a consistent benchmark piece that isolates the costs avoided by the workshare activity. The proper benchmark remains the Bulk Metered Mail piece.

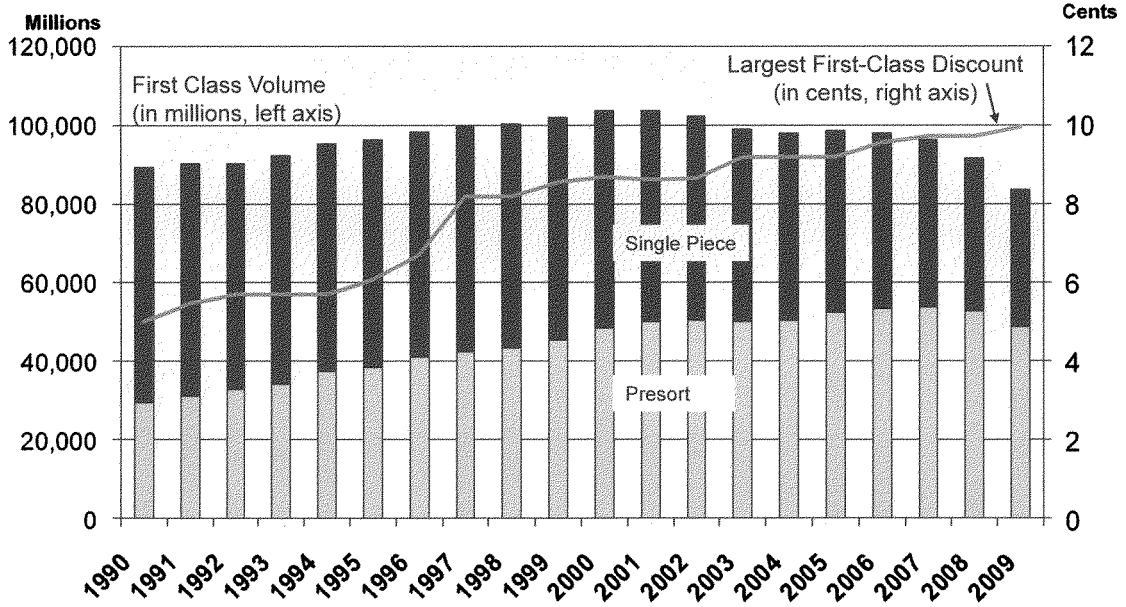
Respectfully submitted,

Darryl J. Anderson
Jennifer L. Wood
Counsel for American Postal Workers Union, AFL-CIO

Graph A

Discounts Do Not Generate Significant Increases in Volume

First-Class Mail Volume and the Largest First-Class Discount
(Volume is Total for the FY and the Discount is the Average for Each FY)



The red line shows the largest discount available for First-Class mail (5-digit automation discount in 2009). Each bar shows the First-Class mail volume for the FY divided into single-piece mail and presort mail. The substantial increase in the discount between 1996 and 1997 did not result in a similar increase in mail volume. The growth in the discount from 2005 forward did not prevent a decline in volume.

Mr. LYNCH. Mr. Buc, you are now recognized for 5 minutes for an opening statement.

STATEMENT OF LAWRENCE G. BUC

Mr. BUC. Chairman Lynch, Ranking Member Chaffetz and other subcommittee members, I appreciate the opportunity to testify this afternoon. My name is Lawrence Buc. I'm the president of SLS Consulting, Inc. I've been analyzing Postal Service costs for 35 years. I'm testifying today on behalf of the Magazine Publishers of America, the Direct Marketing Association, the Alliance of Nonprofit Mailers, the Association for Postal Commerce, the Parcel Shippers Association, the National Postal Policy Council, and National Association of Presort Mailers.

My prepared testimony makes three important points. First the Nation, the Postal Service, mailers and consumers, all benefit from combined total cost of preparing, transporting, sorting and delivering mail.

Second, correctly priced work-sharing gets us there. It's the only way to get lowest combined cost. And it also induces large mail volumes.

Third, setting work-sharing discounts at the right level is complex. I'll now address each of these points in turn.

First, total lowest mailing cost and large mail volumes benefit the Nation and all members of the mailing community. The Postal Service may have a monopoly on the mailbox, but it does not have a monopoly on overall forms of communication. Cost and prices matter to businesses, not profit entities and government organizations as they make decisions regarding the best channel to use for communicating with customers, prospective customers, donors and constituents. That's why it is important to achieve the lowest total mailing cost.

My second point is that work-sharing gets us lowest combined cost and large mail volumes. With work-sharing correctly priced, work will be performed by those who can perform it at least cost. In many cases this will be postal employees. Work-sharing discounts are correctly priced when they equal the cost the Postal Service avoids by the work-sharing activity. That sends the pricing signal that it incents efficient behavior and results in whoever can do the work at least cost actually doing that work.

If discounts are less than costs avoided, the Postal Service performs work that others could perform at less cost. And if discounts are more than costs avoided, others do the work that the Postal Service could perform for less. Both of these unnecessarily increase costs. Work-sharing results in far more mail, both through lower prices and by stimulating the overall use of mail.

According to econometric analysis, Dr. Edward Pearsall, a consultant to the Postal Regulatory Commission, work-sharing is responsible for half of all mail. In other words, there is twice as much mail today as there would be without work-sharing. Without work-sharing, according to Dr. Pearsall, there would be closer to 85 billion pieces of mail, with 169 billion pieces projected for this year. Think about the Postal Service's financial situation with only 85 billion pieces of mail. Actually it's almost unthinkable.

It's important to realize also that the Postal Service has large fixed costs that are not affected by changes in mail volume. More mail lets these fixed costs be spread over more mail volume, and that results in lower prices for all mail. And incidentally, work-sharing mail is more profitable than other mail. For example, Postal Service data show that with first class letters, work-shared prices—work-shared pieces contribute almost a nickel more to Postal Service profitability than do single-piece letters.

My third and final point is that estimating costs, costs avoided and setting work-sharing discounts at the right level is complex. The Postal Service processing, transportation, and delivery systems are large and complex. Consequently, estimating costs and cost avoidances is also complex. My testimony—my written testimony provides several examples.

Under the 1970 Postal Reorganization Act and continued with the new Postal Reform Act of 2006, final responsibility for postal costing and prices was delegated to the Postal Service and the Postal Regulatory Commission. There have been and there always will continue to be differences as to whether the PRC and the Postal Service are getting it exactly right. But generally they are doing a very good job. Not in every single case and not in every single detail. You certainly wouldn't expect perfection in a system this large and this complicated. In general, they have done very well.

Thank you and I will be glad to answer any questions.

Mr. LYNCH. Thank you, Mr. Buc.

[The prepared statement of Mr. Buc follows:]

TESTIMONY OF

LAWRENCE G. BUC

BEFORE THE

SUBCOMMITTEE ON FEDERAL WORKFORCE,

POSTAL SERVICE AND THE DISTRICT OF COLUMBIA

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

U.S. HOUSE OF REPRESENTATIVES

May 12, 2010

My name is Lawrence G. Buc. I am the President of SLS Consulting, Inc., an economic consulting firm in Washington, D.C. I am testifying today on behalf of Magazine Publishers of America, the Direct Marketing Association, Parcel Shippers Association, the Alliance of Nonprofit Mailers, the National Postal Policy Council, the National Association of Presort Mailers, and the Association of Postal Commerce. On behalf of these mailers groups, I thank the Subcommittee and Chairman Lynch for the opportunity to testify in this hearing.

The Subcommittee has asked for testimony on two subjects: (1) whether postal worksharing works, and (2) postal pricing policies. For the reasons summarized here, I believe that postal worksharing works, and is good for the country as a whole, consumers, the Postal Service, and mailers. I also believe that postal costing is a complex topic which underlies worksharing and pricing. Consequently, I endorse the pricing system established by the Postal Accountability and Enhancement Act.

WORKSHARING WORKS

Worksharing is Good for the Country

The goal of worksharing is to ensure that mail is produced and delivered at the lowest possible combined cost. Overall, society is better off if production is organized efficiently so the societal costs of mail are as little as possible. Where the Postal Service can perform work at the lowest cost, it should perform this work. And where mailers or third parties can perform this work at the lowest cost, they should perform the work. If this happens, society produces and can consume mail at the lowest combined cost.

Let's explore what this means in the postal world. From a cost perspective, if letters, magazines, and catalogs can be printed with addresses in ZIP Code or Carrier Route order, it is much less expensive to print them in this order than it is to print them in a random order and then physically sort them. So worksharing produces sorted mail at the least cost.

Consolidators are also very efficient at sorting parcels and trucking them deep into the postal system where the Postal Service's unmatched last mile delivery network finishes the job. Where the consolidators can perform the sorting and transportation for less than the Postal Service, efficient worksharing again results in mail at the lowest combined cost.

Finally, presort bureaus are very efficient at collecting letter mail from mailers both large and small and sorting it by 3-Digit and 5-Digit ZIP Code for entry into the Postal Service. Of course, it would not be cost effective for them to sort to carrier walk sequence since the Postal Service would just have to repeat this operation as they merge mail from numerous sources so there are not discounts for First-Class Mail for this activity.

But efficient worksharing can only occur if Postal prices are set to ensure that the work actually is performed by the party that can perform it at least cost. The way to do this is to have prices that reflect, as closely as possible, the Postal Service's cost savings that result from worksharing. Economists call this Efficient Component Pricing. The Postal Regulatory Commission has long advocated this approach to pricing and so have I.

Under a set of laws and regulations collectively known as the Private Express Statutes (or PES), only the Postal Service can deliver letter mail, and only the Postal Service can put mail in the mail box. Simply stated, the PES provides the Postal Service with a delivery monopoly.

But even the PES monopoly allows competition "upstream services" such as sorting and transporting mail. Worksharing promotes this competition, which in turn promotes the efficient, affordable provision of postal services. As a matter of public competition policy, Postal Service worksharing discounts should generally not be set to exclude more efficient competitors, which would occur if discounts were set below the Postal Service's cost savings that result from the worksharing activity. And, on the other hand, worksharing discounts should also generally not be set to encourage inefficient competitors and increased production costs, which would occur if discounts were set at more than cost avoided.

Worksharing is Widespread but the Postal Service Retains Large Amounts of Mail Processing Work

A large portion of the United States mail stream qualifies for one form or another of worksharing discounts. As shown in the table below—reproduced from a study by Robert H. Cohen and several other professional economists on the staff of the Postal Rate Commission (**Worksharing: How Much Productive Efficiency, at What Cost and at What Price?** in Michael A Crew and Paul R. Kleindorfer, eds, Progress Toward Liberalization of the Postal and Delivery Sector (2005))—of the 206 billion pieces of U.S. mail sent and delivered in FY 2004, 150 billion pieces, or 72.8 percent of all mail, was workshared in some manner. These are the most recent published numbers and there is no reason to believe that the extent of worksharing has changed substantially.

Table 1: Worksharing Avoided Costs and Value of Worksharing Discounts (2004 Millions)

Class of Mail	All Volume	Workshared Volume	Percent of Volume Workshared	Total USPS Cost Avoided ($)	Value of Discounts ($)
First-Class Mail	97,926	50,239	51	$3,466	$3,440
Periodicals	9,135	8,731	96	1,485	1,396
Advertising Mail	95,564	89,762	94	9,297	9,121
Package Services	1,132	626	55	151	108
Other	2,349	-	-	-	-
Total	206,106	149,559	73	14,399	14,065

Despite the fact that worksharing is common, the Postal Service still performs large amounts of mail processing work for mail that is not workshared to the highest degree provided for in prices. In Fiscal Year 2009, clerks and mailhandlers at the Postal Service performed 251.2 million hours of mail processing, evidence that for much work, the Postal Service is the least cost provider.

Worksharing is Good for the Postal Service

While the Postal Service may have a mailbox monopoly, it does not have a monopoly on communications. Companies have many alternatives for marketing, electronic alternatives for most transactional mail like bill and statement presentment, and even alternatives for package delivery. As discussed above, worksharing allows postal services to be performed at the least cost possible, which allows the Postal Service to compete more effectively in all of these markets and thereby increase total mail volume.

But the increases in mail volume are much greater than would be expected just based on the volume response to price. Economist Edward Pearsall, a consultant to the Postal Regulatory Commission (PRC), has published studies showing that the introduction of worksharing discounts induced huge growth in mail volume: worksharing is responsible for almost half of all Postal Service volume. *Said another way, without worksharing discounts, there would be only about half as much mail as there is today.* FY 2009 mail volumes would have been closer to 90 billion pieces than to 180 billion pieces.

For example:

- Between the time Parcel Post sorting and transportation discounts were introduced in 1990 and 2004, worksharing discounts induced volume growth of 294 percent.

- For First-Class Mail the numbers, while less striking, are still powerful. From the introduction of worksharing discounts in 1975 until 2004, worksharing discounts induced volume growth of 96 percent.

If these discounts were eliminated or reduced, there is little reason to believe that history would not just run backwards: while there is currently concern about the Postal Service's financial viability if mail volume drops to 150 billion pieces, imagine if volume declined to 75 billion pieces or less. Looked at this way, worksharing actually drives jobs for postal workers who have twice as much mail to handle.

In addition to being responsible for a large portion of total mail volume, worksharing is a profit center for the Postal Service. It improves the Postal Service's bottom line. Workshared First-Class Mail at current prices is more profitable for the Postal Service than Single-Piece First-Class Mail. In FY 2009, each workshared First-Class Mail Letter produced almost a nickel more of profit for the Postal Service than a Single-Piece Letter.

Furthermore, reducing First-Class Mail worksharing discounts would hurt Postal Service finances. Workshared First-Class Mail is more price sensitive than Single-Piece mail. This means that increasing prices for workshared mail by reducing worksharing discounts would drive away more volume than the lower resulting Single-Piece prices would generate. Magnifying the impact on postal finances, the volume that would be driven away is higher-profit workshared First-Class Mail volumes that provide almost a nickel per piece more of profit for the Postal Service.

On a related point, I'd like to clear up a common misconception: that reducing worksharing discounts would generate additional revenue. This simply will not happen under the Postal Accountability and Enhancement Act's rate index mechanism. Except for the volume effects that I just discussed, the size of worksharing discounts has no effect on the amount of revenue that USPS is allowed to generate under the rate index. For 90 percent of the mail, the index effectively limits revenue increases to inflation. So if prices for workshared mail were higher, the rate index mechanism would require

prices for non-workshared mail to be lower and total revenue generated would remain unchanged. The Postal Service would not be better off, and actually would be worse off, driving away more profitable mail volume.

Worksharing also provides the Postal Service with needed operational flexibility. Just think of how bad off the Postal Service would have been if it had expanded the equipment and sorting space and the number of employees to handle all of the processing of the tens of billions of mail pieces that were lost since 2006.

Worksharing is Good for Consumers

And not unexpectedly, because worksharing results in lowest cost production, it supports universal service by making mail more affordable. It does this by allowing the large fixed costs of the Postal Service to be spread across the far larger volumes that worksharing discounts have induced.

Worksharing is Good for Mailers

Worksharing is also good for mailers and the large portion of the American economy in the public, private, and non-profit sectors that uses the mail for correspondence, transactions, marketing, fund raising, package delivery, and business generally. It allows them to use an input into their production that is produced at the lowest combined cost. This, in turn, allows them to communicate with constituents, donors, and customers; market and deliver products; or raise money for charitable purposes at lower cost. And as described above, it's important to remember that mailers do have alternatives.

Although Postal Service worksharing discounts are based on the costs the Postal Service avoids by virtue of the worksharing, mailers do more in worksharing than just put a barcode on a piece of mail. In a letter to the Subcommittee last year, the National Postal Policy Council provided a list of the activities that a mailer performs in order to have First-Class Letter Mail qualify for automation workshare discounts (the list of activities is reproduced as Attachment 1).

PRODUCT COST CALCULATIONS ARE COMPLEX

Mail processing, transportation, and delivery are complex operations. The Postal Service handles several dozen products through over 300 mail processing plants, over 36 thousand retail postal facilities, through thousands of different transportation trips,

and delivers them with almost 300 thousand carriers. In general, Postal Service data collection systems work reasonably well, given the difficult task at hand.

However, estimating product costs is a complex multi-step process relying on both data collection systems and methodology. After forty years of litigation at the PRC, there are still disagreements between the Commission, the Postal Service, and other interested parties on the exact methods that should be used in particular areas and on data collection issues. And both are important—a tweak here can mean hundreds of millions or even billions of dollars there.

Following, I provide examples of the some of the complexities involved in postal costing.

Calculating Total USPS Costs. At first blush, what could be easier than determining the total cost of any large enterprise, such as the Postal Service? After all, the Postal Service maintains accounting systems and financial controls. Surely there can be no controversy over total costs.

But there is. First, recall that the Postal Service reports costs on an accrual basis, but expenditures and receipts are on a cash basis. Cash accounting must first be converted to accrual accounting. There are issues of the correct depreciation period and how to account for postage that has been purchased by the American public, but not yet used. And there are issues of the correct discount rate to be used to estimate Workers' Compensation costs. Further, there is significant disagreement between the Postal Service's Office of Inspector General and the Office of Personnel Management regarding the Postal Service's Civil Service Retirement System (CSRS) and retiree health benefit costs. As another example, the Postal Service carries real estate on its books at book value (purchase price minus depreciation), not at market value. Its financial position might look better if real estate were "marked to market" as securities are.

Determining Costs by Shape. For product costs to be correct, costs often must be correctly determined for each mailpiece shape. In 2001 my consulting firm noticed anomalies in Standard Mail parcel costs and pointed them out to the Postal Service. In the rate case that followed, the Postal Service adjusted its costs for flats and for parcels to reflect the fact that the In-Office Cost System ("IOCS")—the basis of a large portion of Postal costing—was assigning costs to Standard Mail parcels that actually belonged to flats. The adjustment reduced Standard parcel costs by 25 percent, from 80.7 cents to 61 cents and increased flats costs from 13.0 cents to 14.7 cents. And, prices were adjusted to better reflect the real costs.

Variability of Mail Processing Costs. Postal costing relies on the concept of attributable costs, which are generally costs that change as mail volume changes. This concept is important because only attributable costs are relevant in determining whether a class or product covers its costs. Over a number of years and a number of rate cases litigated under the Postal Reorganization Act ("PRA"), there was considerable controversy over the degree to which mail processing costs change as mail volume changes. The Postal Service provided sophisticated (and I believe correct) econometric evidence to show mail processing costs changed less than mail volume, meaning that well less than 100 percent of mail processing costs were variable and thus should be distributed to product. The PRC rejected the method, leaving almost all mail processing costs to be distributed to product. Had the PRC accepted the method, the costs attributed to mail classes and individual products would be lower and the cost coverage of mail classes and individual products would be higher.

Excess Capacity. It is widely understood that the Postal Service currently has excess capacity in its operations. This has two significant implications for postal costing. First, Postal Service costs are higher than they would otherwise be, which is a burden on all mailers and the entire nation. Second, since there is no reason to believe that excess labor is spread equally across postal functions, the added cost may not be evenly spread to all products: some products may be disproportionately burdened with the cost of excess capacity.

Impact of Presortation on Mail Processing Costs. The IOCS does not collect cost data by workshare category so the Postal Service must disaggregate IOCS costs to estimate the costs avoided by worksharing. The disaggregation relies on special studies, which estimate not only how worksharing affects direct sorting costs, but also how it affects USPS costs for allied functions, those that support direct sorting. In the 2006 rate case, I showed that many allied functions and some direct sorting activities that the Postal Service assumed were unaffected by worksharing actually were affected by it and the PRC largely accepted my recommendation. Today this remains the accepted method for calculating Postal Service workshare cost avoidances for presorting and barcoding letters.

These examples illustrate why postal costing is and should remain the domain of experts at the Service, the PRC, and the mailing community, all of whom participate in cost method changes under rules promulgated by the PRC. And the Postal Service does propose changes in cost methods—43 times in the last two years. There are open, transparent proceedings at the PRC to consider these changes. Anyone can participate. And anyone can propose changes or new methods.

And because costing is a complex topic and it underlies pricing and ratemaking, Congress, correctly, has established an expert body—the PRC—to consider cost coverage, market demands, rate shock, and the effect of rate increases on the mail and the economy. Congress wisely removed itself from costing and from rate making in 1970 when it passed the PRA. And it did so again in PAEA, wisely leaving costing and pricing to the experts.

ATTACHMENT 1

In a June 2, 2009 letter to Chairman Lynch, the National Postal Policy Council discussed activities that a mailer must perform to qualify for a discounted First-Class Mail letter rate of 33.5 cents:

- Design a mail piece to be automation compatible with the size, fold, weight, thickness, fonts, address position, etc., to meet USPS requirements.
- Put a complete delivery address with correct ZIP Code or ZIP+4 Code on each piece.
- Update the addresses for customer moves on all mail pieces within 95 days before mailing through a USPS-approved address update method.
- Within 12 months before mailing, use a certified process to ensure the accuracy of 5-digit ZIP Codes.
- Mark each piece "Presorted" or "PRSRT" and "First-Class Mail" in the postage area, or in another location specified by the Postal Service.
- Enter the mail at a USPS facility designed to accommodate the entry of bulk mailings.
- Enter at least 500 or more addressed pieces at a time.
- Enter the mail in trays, with each piece oriented in the correct direction.
- When preparing full trays, fill all possible 2-foot trays first; if there is mail remaining for the presort destination, use a combination of 1-foot and 2-foot trays that result in the fewest total number of trays for that presort level.
- Label each tray with a 2-inch tray label or a barcoded tray label.
- Sleeve the trays and, with few exceptions, strap them too.
- Present the trayed mail on pallets grouped by the local USPS requirements and definitions for specific pallet sorts.
- Submit a USPS-authorized postage statement or approved facsimile along with the pieces.
- Supply supporting documentation unless the correct price is affixed to each piece.
- Maintain documented quality control procedures that define the management of mailing systems and postage payment.

Mr. LYNCH. Dr. Riley, you are now recognized for 5 minutes.

STATEMENT OF MICHAEL RILEY

Mr. RILEY. Thank you for letting me testify before you. I am here because I care about the Postal Service as an institution. I care about the people and I care about the customers and I don't like the way things are going. The Postal Service is dying from self-inflicted wounds because it has discounts that have gone crazy, and they need to be scaled back.

Vice President Robinson testified that the Postal Service would never do anything to harm its customers or any segment of its customers. And to that I say: Well, stop with the Saturday delivery plan, do not end Saturday delivery, keep the thing going.

And while I've got your attention, I would like to make two more proposals to you. I think the law needs to be changed, the retiree health-care provision in the 2006 act needs to be changed to put the Postal Service on the same position as any other major company in this country and ought to be structured like a mutual insurance company or mutual savings and loan, so that people realize it needs to earn a profit to provide the capital for new products, for new buildings, for expanded service, for converting the fleet to hybrid vehicles instead of the old-fashioned 1995 long-life vehicles still out there.

I'm going to give you a little background. In 1994, in spring, I sat before this committee with Chairman Bill Clay, and I'm going to show you a graph as to what it was like. Then the worst-ever year of the Postal Service happened in 1993, and I joined Marvin Runyon in August, with 6 weeks to go in that year. In the spring of 1994 I sat before Congressman Clay, and I walked up to him today and said, You know, I testified before your father back in 1994 and he was very——

Mr. LYNCH. The Honorable Mr. Clay is here today. I just want to acknowledge that.

Mr. RILEY. And he let me go for a bit, and said his father died in 1976. I apologize to you for mistaking one for the other.

I'm going to tell you one more story. Back here a Congressman named Steny Hoyer, who was rising in the House of Representatives, told Marvin Runyon he was full of beans when Marvin said, I've got the place turned around. He said, I'll eat crow if you can turn this place around. And I was at the ceremony where Congressman Hoyer came to the Postal Service and cut the first piece of cake in a giant crow cake. He made a wonderful speech.

The Postal Service had 4 years of billion-dollar profits, and it did it because it focused on the individual as the recipient. We had a balance score-card strategy focusing on the customer, the employee, and the finances of the Postal Service. We had an incentive system that backed it up.

And Marvin Runyon—this chart goes only to the third quarter of 1998, because that's when Marvin Runyon stepped down as Post Master General and when I stepped down as CFO. This is the chart I showed the board of Governors at my last meeting as CFO. At the time, the major mailers were saying the Postal Service is earning too much money, way too much money. Profits are excessive. And new management promised to solve that problem, and

solve it they did. They managed to get almost nonstop billion-dollar losses, with the exception of 3 years, thanks to the work of a guy named Bill Tayman, who was able to get the government to realize they were overcharging the Postal Service for CSRS retiree costs.

The Postal Service has excess discounts. Congressman Connolly summed up my position exactly when he said that when you have a way to save money, you save it equally; you save it so the Postal Service gets some of the benefit and so the mailer gets some of the benefit.

Vice President Robinson said, Well, gee we have this percentage markup, and as I tell my MBA students, you can't spend percentage, you can only spend cash. And because focusing on the wrong things—and the Postal Service has—it has a strategy that focuses on the representatives of the major mailers as customers, it focuses on productivity, and frankly productivity is applied as service. If you cut one person up behind the window and have an hour line wait, that means your productivity goes up. But it sure doesn't mean the customers like you any better.

I for one used to be an avid postal customer. I got cured from having bad problems with the Postal Service in the last 2 years. The Postal Service needs to put the service back and focus back on the individual customer and not on just the discounts and who can justify the biggest share for their person.

When we were having record profits for 4 years, we didn't have to have a price increase. And that benefited the major mailers. And I would argue that today the Postal Service has driven away its customers.

I was showing one of the Representatives earlier today in the room, the Annual Report of the Post Master General of 1872. The Postal Service has been crying the sky has been falling because of the electronic version for 1882. Back in 1993, we had a report that said the Postal Service was losing huge market share every year to e-mail. My kids got their first computer in 1983, but in 1872 the Post Master General complained that with the recent advances in mystic Casini's fax machine, the Postal Service is going to be completely threatened with going out of business. 1872. It took 100 years for the fax to come in. When it finally did, it was gone in 20.

And I've used my time, Mr. Chairman. Thank you. I would ask, in summary, make them scale back the discounts, change the law to help on the retiree costs and the profits, and do not let them go to 5-day-a-week delivery.

Mr. LYNCH. Thank you.

[The prepared statement of Mr. Riley follows:]

Dr. Michael J. Riley's Testimony Before the Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia

May 12, 2010

Mr. Chairman and members of the Committee, thank you for inviting me to testify. And thank you for holding these hearings on work-share discounts. Work-share discounts are a very significant, but too little understood, part of the ongoing debate about the financial welfare of the United States Postal Service. From 1993 to 1998, I served as Senior Vice President and Chief Financial Officer (CFO) of the Postal Service. That service gave me knowledge and insight that I hope will be useful to you as you consider work-share discounts. I am a Professor of Business and Executive Programs at the University of Maryland University College, and I also have my own consulting company. In addition, I serve on the board of directors of Church Mutual Insurance Company and as chairman of its audit committee. I served as chairman of the audit committee of the Architect of the Capitol from 2003 to March 2010. My experience also includes service as CFO of Lee Enterprises, CFO of United Airlines, and Treasurer of Michigan Bell Telephone Company. I have appended a brief biography to this testimony for your reference.

I am providing this testimony because I care about the Postal Service as an institution, I care about postal employees, and I care about postal customers. Focusing first on the topic of today's hearings, I recommend that Congress stick to the requirement, already in law, that postal work-share discounts may not exceed the costs that the work-sharing activity saves the Postal Service. Recent actions by the Postal Service that violate that standard are misguided and are damaging the institution by depriving it of much needed revenue and, more importantly, money needed to cover fixed costs. Efforts by the Postal Service and large mailers to separate work-shared mail from other First Class letter mail in order to increase their work-share discounts should be rejected.

I would be remiss if I did not also comment on two related postal issues while I have this opportunity. The first is the Postal Service's proposal to largely eliminate Saturday mail delivery. This is a misguided and damaging proposal. This is the result of the failure of the Postal Service to price its products correctly and a miscalculation of the damaging effects of cost cutting measures on the ultimate customer, the individual receiving the mail. This proposal will exacerbate the trend toward electronic substitution for the mail. The Postal Service should be increasing and improving the services it offers not reducing them. The Postal Service is, quite literally, selling itself short. That strategy could prove to be the blow that may destroy any hope for future financial viability.

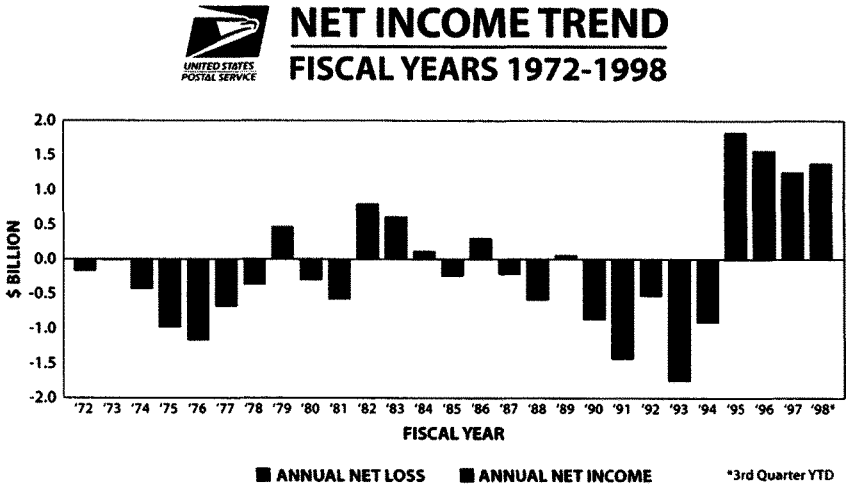
The second issue I must mention is the burden created by the advance funding requirement for retiree health benefits. This is not the place nor the time to engage in an extended discussion of that issue. Still, I strongly recommend that Congress repeal that requirement. The Postal Service should operate in the same way as other large employers in the way it provides for retiree health benefits. Typically, companies pay for retiree health benefits as the costs are incurred, rather than paying them in advance as the Postal Service is required to do.

In addition, it is my recommendation that the Postal Service should be structured similar to a mutual savings and loan or mutual insurance company. This would allow the Postal Service to accumulate profits as surplus to provide cash for new vehicles, equipment, buildings, new

products and services, and to have a cushion to weather economic downturns. The law requires the Postal Service to break even over time. This means that a significant recession, such as the one we're in, threatens the financial viability of the Postal Service.

Background

At the end of the 3rd quarter in fiscal year 1998, the Postal Service reported a year-to-date profit of $1.4 billion, improved customer satisfaction, and higher employee morale. Four years of billion dollar profits had allowed the Postal Service to pay off $4 billion in debt and to triple capital spending. A graph showing the financial history of the Postal Service through the 3rd quarter of fiscal year 1998 is provided below.



As is shown above, the profits from financial year 1995 through 3rd quarter 1998 totaled $6 billion. These profits were used as capital to build post offices in new communities and to make major investments in equipment that improved accuracy and reduced costs. Despite a ten-year explosion of Internet use, mail volume rose nicely and the Postal Service was able to maintain the 32-cent price of stamps for four consecutive years.

The strategy was based on the Balanced Scorecard Model with equal emphasis on the customer, the employee, and the financial viability of the Postal Service. There was recognition that convenience, courtesy, safety, security of the mail, trust, consistency, and price were essential parts of the value mix. The primary customer was the individual. It was and is the preference and the response of the individual to mailings that drives mail volume. E-mail and electronic bill paying generally have no cost per use and therefore, the other elements of the value proposition matter more than the price of postage.

New Management and Strategy

There was a management change at the end of the 3rd quarter of 1998. Many in the mailing community expressed their feelings that the Postal Service was earning too much money and that the profits were excessive. New management promised to solve that problem, and solve it they did. Billion dollar profits were replaced by billion dollar losses.

Instead of emphasizing the value of its products and prioritizing revenue protection, management focused on cost reduction—not just through further automation and streamlining of postal networks, but through cuts in service. This strategy seems to have hit rock bottom with the proposal to eliminate Saturday delivery and close facilities needed to provide universal service.

This counterproductive shift in strategy was, ironically, made possible by the financial success of the Postal Service in the 1990s. New management changed the business strategy to one that focused solely on productivity and discounts, rather than the total value mix outlined above. Management began to view the primary customer as the representative of the large mailer instead of the individual consumer. These representatives focus on obtaining discounts for their clients, the large mailers, and /or converting first class mail to less expensive categories of mail.

The apparent goal of the Postal Service was to grow volume and restrain or eliminate price increases. Neither goal was achieved.

Discounts

The Postal Service said that if prices were cut, then volume would increase. This was generally true, but deceptive. Some of the services had price inelastic demand. As an example, if the Postal Service cut prices by 10% for a large mailer and achieved a 2% increase in volume, revenues would drop by 8%. Clearly, this was a financial problem.

Even if revenue increased slightly, as is the case with elastic demand, the effect would be negative on money to cover fixed costs and profits, and it would speed up the need for a rate increase. To illustrate, consider a $1 billion service with a 25% contribution margin. This means that direct costs would be $750 million and contribution, money to cover fixed costs, would be $250 million.

Now, consider what would happen if the Postal Service cut price by 10% and revenue dropped to $900 million. If volume increases 15%, revenue now becomes $1,035 million ($900 million x 1.15 = $1,035 million). The fact that revenue increases with a price cut does not mean that this price cut is beneficial.

A 15% increase in volume also means that costs go up 15% to $863 million. What appears to be a situation that leaves the Postal Service better off by the 3.5% increase in revenue actually hurts the financial condition dramatically. Contribution falls by 31% despite the revenue increase. Because costs rise to $863 million, the Postal Service has $78 million less cash to cover fixed costs. The table below shows this effect.

THE EFFECT OF PRICE CUTTING: FINANCIAL DISTRESS

	Original Case	10% Price Cut	15% Volume Increase	Difference
Revenue	$1,000	$900	$1,035	+$35
Attributable Costs	$750	$750	$863	($113)
Contribution	$250	$150	$172	($78)

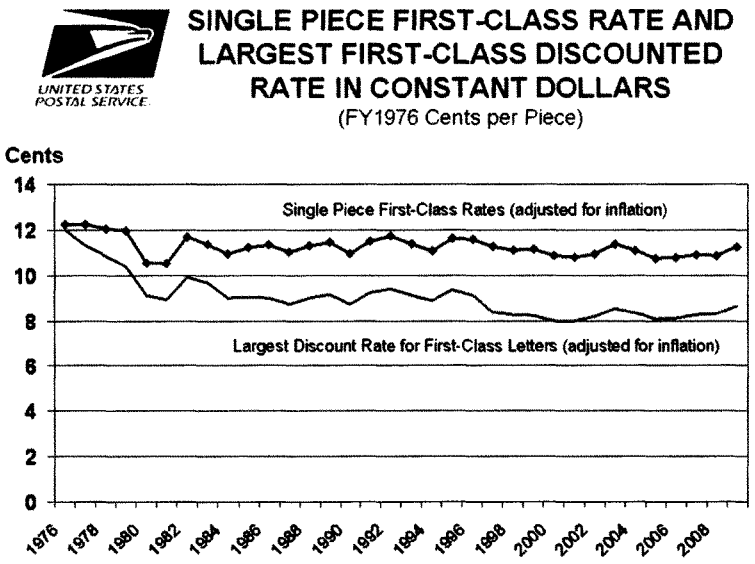
When a mailer can sort mail in the computer, the Postal Service saves costs. We should expect the Postal Service to share the benefit with the mailer through work-share discounts. But, rather than share the benefits equally between the Postal Service and the mailer, work-share discounts grew to give away all of the savings and more too. The initial result was slightly more mail and substantially less contribution to cover fixed costs. Of course, with the recession, mail volume is now down by a very large amount.

Work-share discounts equal to costs saved are still too high. Work-share discounts should be less than costs saved to provide added contribution to the Postal Service. In conclusion, the under-pricing of mail is a significant reason for the Postal Service's current financial distress.

Inflation and Mail Volume

The price of a first class stamp has risen slightly less than inflation during the period from 1976 to the present. As we would expect for a service business, this has not protected mail volume. Other elements in the consumer value mix are more important.

The graph below compares the price of a single first class stamp and the rate for the most discounted work-shared mail adjusted for inflation. As you will see, both single stamp prices and work-share rates have increased less than inflation since 1976. This graph also shows the increase of work-share discounts relative to the price of a single first class stamp over this period.



Mail volume has grown over the years and recent volume declines are unrelated to the prices. Only an end to the recession promises to restore volume.

Saturday Delivery

The Postal Service has projected great cost savings from the elimination of Saturday delivery. It assumes that this will have no effect on revenue and that is naïve. It is one strong signal to customers that the Postal Service is slowly going out of business. If only 10% of customers give up on the Postal Service and convert to electronic bill paying, that will offset any projected savings.

But far more important is the direction of Postal strategy. The elimination of Saturday delivery is in direct opposition to the idea of the individual as the primary customer. Successful businesses find ways to delight various segments of their customer base. At best, many customers will not care about the elimination of Saturday delivery, while many will certainly be distressed.

This is a step that will not be easily reversed.

And the following promise is one of failure. "Eliminate Saturday delivery and 'only' lose $115 billion over the next 10 years." This is hardly a rallying cry for success.

Today

After 12 years, the price of a stamp is 12 cents higher than in 1998 and mail volume is lower. Instead of billion dollar profits, the Postal Service needed an emergency $4 billion bailout from Congress last September and still lost $3.8 billion in 2009. There is no money for capital and anecdotes abound about dissatisfied customers.

In June 1998, the Consumer Price Index stood at 163.0. It increased to 217.6 in March 2010, an increase of 33.5%. The price of a first class stamp is 37.5% higher than it was in June 1998. Despite increasing the price of the stamp to the public, the Postal Service has gone from a strong financial position to one of financial disaster.

There are 2 small positive innovations in an otherwise bleak outlook.

The Forever Stamp is a customer convenience and likely produces savings enough to cover the costs. It costs the Postal Service about 1 cent to create, print, and distribute a new 1-cent stamp. This means that there is no net loss by allowing customers to use the forever stamp. Customers tend to misplace and lose some percentage of their stamps and the Postal service earns a return on their funds paid in advance of need. So, the Postal Service can provide a convenience that Customers like and added value without cost.

The new advertising campaign, "If it fits, it ships," focuses on value, not discounts. The customers like getting "free" boxes and enjoy the convenience of not having to weigh the package to figure out postage.

No Cash for Opportunity

There are numerous opportunities for improvement to delight customers and thereby increase mail volume. Unfortunately, the Postal Service lacks the money to implement these initiatives in its current state. The following is a short list of examples:

- Advertise 7 day-a-week delivery of Express Mail.
- Open a window at mail processing facilities for 24 hour, 7 day a week mailing similar to what used to be the case at National and Dulles airports.
- Use the Internet and password protected communications to allow retired individuals to direct their mail to multiple locations while away from home. This is a variation of the current "Snow Bird" mail service.
- Advertise the current "Snow Bird" mail service. The $15, once a week, Priority Mail Forwarding program, earns the Postal Service $60 in revenue per month for a service that costs less than the current free mail forwarding program. In fact, this service should be expanded to offer the service for 2 or 3 days each week if desired.
- Return to the 5-minute line wait policy. Last Christmas, I turned around from my local Post Office with an hour wait and mailed my presents at the UPS store. The wait there was 10 minutes.
- Open high-volume, high-service locations for the mailing public with very friendly employees. Merrifield, VA has such a location. It has been open 7 days a week and has been open as late as 10 PM.

- Use direct mail advertising to inform customers about such locations. Direct mail advertising works very well. The Postal Service should try it for its own advertising.
- Improve the speed and reliability of mail other than First Class. Certified mail is not reliable nor is it fast.
- Provide locked package lockers to individuals to allow secure package delivery while the customer is away from home during the work day.

It should be noted that this list is far from exhaustive and focuses on the individual as the primary customer.

10-Year Plan

On March 2, 2010, the Postal Service issued a press release that predicted losses of $238 billion over 10 years on its present track and promised to limit these losses to only $115 billion if Saturday delivery is eliminated.

Confucius, Henry Ford, and Will Smith have all said: "If you think you can, you are right. If you think you can't you are right." When it comes to a strategy for financial success, it appears that the Postal Service thinks it can't.

Rather than forecast dramatic losses, it would be far better to devote the energy to a dramatic change in direction to achieve long-term success. The Postal Service can be profitable, customers can be delighted, and the employees can be managed well. All it takes is the right leadership, leadership that thinks it can succeed.

Tomorrow

The Postal Service needs a business strategy that works. It needs to increase profitable revenue to provide capital for replacement equipment, vehicles, and new or improved services that will delight customers. With a different focus, long-term success is possible. Indeed, with the right focus, success is highly likely.

Congress can help. It can keep the requirement already in law that postal work-share discounts may not exceed the costs that the work-sharing activity saves the Postal Service. It can mandate the continuance of Saturday delivery. It can amend the Postal Accountability and Enhancement Act of 2006 to eliminate the pre-funding of health care costs and thus put the Postal Service on par with other large companies. It would be very helpful to also recognize the need for a surplus created by profits along the lines of a mutual company.

Thank you,

Michael J. Riley, DBA

Biography of Michael J. Riley, DBA

Dr. Michael J. Riley is a Professor of Business and Executive Programs at the University of Maryland University College. He teaches finance, economics, and accounting to MBAs and executive MBAs. In addition, he has taught marketing and strategy. He also owns his own consulting company, Riley Associates, LLC.

His business career includes service as CFO of the U.S. Postal Service from 1993 to 1998.

Previously he was CFO of Lee Enterprises, CFO of United Airlines, Treasurer of Michigan Bell Telephone Company, and Assistant Controller of Northeast Utilities.

He serves on the Board of Directors of Church Mutual Insurance Company and is Chairman of its Audit Committee. He was Chairman of the Audit Committee of the Architect of the Capitol from 2003 to 2010.

Dr. Riley earned a Doctor of Business Administration from Harvard University, an MBA from the University of Southern California, and a BS from the U.S. Naval Academy. He has served as an adjunct faculty member at Harvard University, Boston University, University of Connecticut, University of Michigan, and George Mason University.

Mr. LYNCH. Mr. O'Brien you're now recognized for 5 minutes.

STATEMENT OF JAMES O'BRIEN

Mr. O'BRIEN. Mr. Chairman, my name is Jim O'Brien. I'm the vice president of distribution and postal affairs for Time Inc., the largest magazine publisher in the United States. I'm testifying today on behalf of Time Inc. and the Magazine Publishers of America, the industry trade association for consumer magazines.

About 90 percent of printed magazines in this country are delivered to their readers via the Postal Service. Time Inc. and the MPA care greatly about the Postal Service, its financial situation, its future viability and its effectiveness in controlling the costs of periodicals class.

We have been longtime partners with the Postal Service in examining postal and mailer operations to improve efficiency, streamline mail processing, and reduce costs.

In 1998, I participated in a joint USPS Periodicals Mailers Task Force. We visited 17 postal facilities at all hours of the day and night to see every step in the processing of periodicals mail. Following our 1998 joint task force, the Postal Service issued a strategic improvement guide for flat processing. A main focus of the guide was to reduce the manual processing of periodic mail. To do our part, Time Inc. and MPA members had made significant investments in an ongoing effort to identify and implement ways to minimize the work required for the Postal Service to process and deliver our magazines.

I brought with me today a carrier route bundle of Time magazine. Bundles like this are trucked by Time Inc. from our printing plants to USPS facilities that are located very close to the subscriber's zip code. This bundle remains intact throughout the process until it is opened by the letter carrier. This is the most efficient product that we can deliver to the Postal Service. The Postal Service and the Postal Regulatory Commission agree that preparing mail in carrier route bundles saves the Postal Service money.

In 1989, 29 percent of periodicals mail was sorted to the carrier route. In 2009, carrier route sorted mail grew to more than 55 percent. However, despite the industry's successful efforts to improve efficiency and reduce cost for the Postal Service, periodicals costs, as measured by the Commission, continue to outpace inflation.

Why hasn't the Postal Service been able to take advantage of the industry's cost-cutting efforts and its own investments and equipment to improve automation? I have learned from many years of analyzing postal operations and cost that the key problem facing the Postal Service and the major reason for the continuing increase in periodicals cost is excess capacity. In my experience, excess capacity often leads to manual processing, despite the availability of automation. And manual processing leads to increased costs.

The strategic improvement guide for processing was crystal-clear on this point. The report states, "The inability to capture and process bar-coded flats through automation results in a significant cost differential. In fiscal year 1997 we failed to automate over 6 billion bar-coded flats."

Mr. Chairman, I visited a postal facility just 3 weeks ago and observed an operation that the USPS refers to as a "bull pen," which

is an entirely manual operation. Saw that 3 weeks ago. After spending billions of dollars on automation, the USPS continues today to manually process periodicals mail. This manually processed—this manual processing isn't requested or desired by periodicals mailers, it is the result of choices made within the Postal Service. Yet the Postal Service attributes these costs to the periodicals class.

In analyzing costs, the Postal Service assumes that all costs are incurred efficiently and that all worker time and other resources spent on processing a particular class of mail are needed by and of benefit to that mail. Charging periodicals for the extra costs of manual processing that periodicals publishers did not request and do not need is unjust and unreasonable.

The bottom line is while the magazine industry has provided the USPS with more cost-effective mail, periodicals unit costs as measured by the Commission have risen since 1986 by more than 300 percent, 107 percent above inflation. Between fiscal year 2006, the year in which the PIAA was enacted, and fiscal year 2009, the CPI increased by 9.8 percent. Periodicals unit costs as reported by the Postal Service increased by 24 percent.

Something is clearly wrong with the cost attribution process in the manual processing of periodicals mail. Periodicals mailers should not be asked to shoulder the burden of cost they did not cause. Thank you.

Mr. LYNCH. Thank you, Mr. O'Brien.

[The prepared statement of Mr. O'Brien follows:]

Committee on Oversight and Government Reform
Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia

Written Testimony of James O'Brien
Vice President, Distribution and Postal Affairs
Time Inc.

May 12, 2010

Mr. Chairman and Members of the Subcommittee, my name is Jim O'Brien. I am Vice President of Distribution and Postal Affairs for Time Inc. The largest magazine publisher in the United States, Time Inc. publishes 22 magazines in this country. Each month, one out of every two American adults reads a magazine from my company.

I am here today for Time Inc. and the Magazine Publishers of America, the industry association for consumer magazines. The MPA represents approximately 225 U.S. publishing companies with more than 1,000 titles.

About 90 percent of printed magazines in this country are delivered to their readers via the Postal Service. So Time Inc. and the MPA care greatly about the Postal Service, its financial situation, its future viability, and its effectiveness in controlling the costs of the Periodicals class that we use to deliver our magazines.

We have been long-time partners with the Postal Service in examining postal and mailer operations to improve efficiency, streamline mail processing, and reduce costs. In 1998, I participated in a joint USPS/Periodicals mailers task force. We visited seventeen postal facilities at all hours of the day and night to see every step in the processing of Periodicals mail. I continue to visit postal facilities regularly to observe operations and examine areas for improvement. My most recent visit was only three weeks ago.

These examinations have produced results. Following our 1998 joint task force, the Postal Service issued a Strategic Improvement Guide for Flats Processing. A main focus of the guide was to reduce the manual processing of Periodicals mails. To do our part, Time Inc. and other MPA members have made many changes to our magazines and preparation processes over the years to make our mail easier and less expensive for the Postal Service to handle. Despite our best efforts, however, the Postal Service's reported cost of Periodicals mail has continued to rise. This trend deeply concerns the publishing industry. I appreciate the opportunity to give my perspective on these issues here.

The Value of Magazines to the Postal Service and the Public

Magazines are extremely valuable to the Postal Service and the public, as the Postal Service and Congress have long recognized. More than one Postmaster General has called magazines "the anchor in the mailbox"—i.e., mail that consumers really look forward to receiving and that draws them to their mailboxes every day. This value has

been confirmed by the Postal Service's Household Diary Study, which shows magazines right behind packages as the type of mail households like the most.

Congress has repeatedly recognized the value of magazines to educate, elucidate, and inform the citizens of this nation. Periodicals have received special consideration under postal laws since the founding of the nation. This longstanding tradition was continued in both the Postal Reorganization Act of 1970 and the Postal Accountability and Enhancement Act of 2006, which require consideration of "the educational, cultural, scientific, and informational (ECSI) value to the recipient of mail matter" in setting postal rates. Magazines possess ECSI value in abundance.

The importance of Periodicals to the Postal Service extends beyond the hard copy magazines we mail. The Postal Service profits greatly from Periodicals publishers' use of other classes of mail—especially First-Class Mail and Standard Mail. To generate subscriptions and provide customer service, Periodical publishers send large volumes of subscription promotions, gift subscription offers, acknowledgments of subscriptions, invoices, renewal notices, reminder notices, ancillary and cross-product promotions, and other correspondence with customers. Most of this mail is sent via automated letter-shaped First-Class Mail and Standard Mail.

Although our volume of promotions mail has decreased during the recession, when I analyzed Time Inc.'s postage in First-Class Mail and Standard Mail several years ago, the results were quite significant. For every dollar we spent on Periodicals postage, we spent 75 cents on First-Class and Standard Mail on magazine-related mailings. These are the categories of mail with the biggest profit margins for the Postal Service.

Publishers Have Worked Hard to Reduce Processing Costs for Periodicals

The magazine industry has been and remains deeply concerned that the attributable costs of Periodicals, as measured by the Commission, have increased more than inflation over the last 25 years. This trend is especially disturbing to us because MPA and its members have devoted a great deal of time and resources during the past two decades in an ongoing effort to identify and implement ways to minimize the work required for the Postal Service to process and deliver our magazines. From FY 2004 to FY 2009 alone:

- The percentage of Periodicals pieces sorted to the most-efficient and least-cost Carrier Route level increased from 47 to 55 percent;

- The percentage of Periodicals pounds privately shipped and entered at a destination facility rose from 57 to 65 percent; and

- The number of sacks – more expensive for the Postal Service to handle than pallets – declined by 65.9 percent. In FY 2000, Periodicals mailers used approximately 110 million sacks. Today, we use 28 million sacks.

I brought with me today a bundle of copies of Time Magazine prepared to maximize efficiency for the Postal Service. All the pieces in this bundle are destined for the same

carrier route. We truck bundles like this from our printing plants to hand off the magazines to the USPS at facilities near our subscribers. The bundles remain intact throughout the process, and no one has to open them or handle individual pieces until the bundles are opened by the letter carriers who make final delivery of the magazines. Other than taking the bundles to the destination ZIP Code and handing them to the letter carrier ourselves, this is the most efficient product that we can give to the Postal Service – and we and other publishers are making up more bundles like this all the time.

This improvement in preparation – while very beneficial to the Postal Service – is costly to publishers. We must pay printers, consolidators and truck companies for co-mailing, co-palletization and trucking. We have incurred these extra costs in order to stem the increases in Periodicals costs. And it worked. Periodicals costs were relatively flat between 1999 and 2003. However, despite our significant investments to improve efficiency and reduce costs for the Postal Service, Periodicals costs – as measured by the Commission – have once again begun to outpace inflation.

Excess Capacity Has Prevented Potential Cost Savings from Being Realized

The Postal Service's extensive investment in equipment to automate flat-shaped mail should have led to significant reductions in mail processing costs for flats, including Periodicals. Similarly, mailer efforts to make Periodicals cheaper and easier for the Postal Service to handle should have reduced the Postal Service's costs.

But that hasn't happened. Why?

We have learned from many years of analyzing postal operations and costs that a key problem facing the Postal Service – and a major reason for the continuing increase in Periodicals costs – is excess capacity. This excess capacity has been created by the failure of the Postal Service to reduce its workforce when its workload has declined.

There are multiple reasons for workload declines for the Postal Service, including:

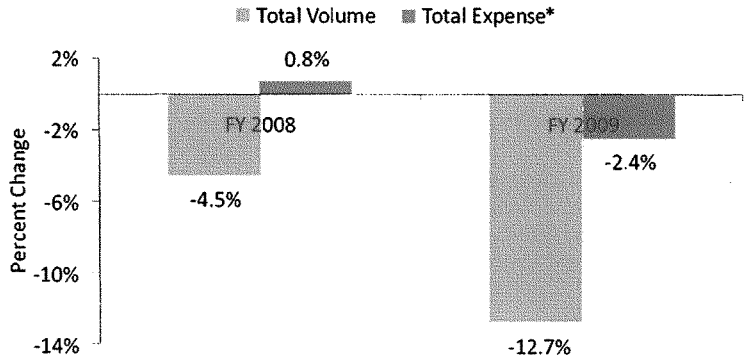
- increasing automation of the mail processing function, which has reduced the number of processing clerks needed for a given processing operation;
- changes in mail preparation that eliminate some of the processing and transportation that the Postal Service used to do;
- and in recent years, shrinking mail volumes.

The Postal Service's workforce, however, has not shrunk as fast as the Postal Service's workload. This is not a new problem. In fact, the increases in Periodicals costs can be tracked back to 1986, when the Postal Service started its letter mail automation program. Time Inc. even coined a phrase to explain what happened to Periodicals as a result of letter mail automation. The term is "automation refugees," and over the years more and more people have come to understand what that concept means. It means that excess capacity in one processing operation can make another processing operation less efficient. Machines are idled while manual processing occurs in order to absorb the

available labor capacity, and classes that had nothing to do with the automation see their costs go up.

The excess capacity problem that we noticed early for Periodicals has worsened and broadened in the past few years with significant declines in mail volume.

The chart below shows the magnitude of the problem in the last few years. Adjusting for differences in amounts paid into the Health Benefit Fund in 2007-2009, the chart shows that in 2008 total mail volumes declined 4.5 percent but expenses actually increased. Similarly, in 2009, total mail volumes declined almost 13 percent but costs decreased by only 2.4 percent.



*For consistency, FY 2009 costs adjusted to reflect full $5.4 billion RHB fund payment and FY 2007 costs adjusted to exclude transfer of escrow to RHB fund.

In my experience, excess capacity often leads to manual processing despite the availability of automation. And manual processing leads to increased costs. In the Strategic Improvement Guide issued by the Postal Service after our 1998 joint task force, the Postal Service quantified the problem, circa 1997: "In FY97, we failed to automate over 6 billion barcoded flats – and had we processed them through automation, we would have saved over $54 million."

When I have visited postal facilities over the past 13 years, I have often observed flat sorting machines standing idle while Postal Service personnel sorted Periodicals manually rather than running them on the machines. This doesn't happen in the case of letter mail, because the Postal Service removed manual letter cases from its facilities. But manual processing areas for Periodicals remain.

In a postal facility in the New York area, just three weeks ago, I saw an operation that the Postal Service informally refers to as a "bullpen." A sign at the top of the bullpen said "Hot Publications Staging Area." Inside the bullpen, were hampers for mail handlers to manually sort bundles of Periodicals. Why do manual processing areas continue to exist

in so many processing facilities? Facility personnel, when asked about manual processing, sometimes claim it is done for "service reasons." But I have never asked for manual processing, and I don't think other publishers have either. In fact, the reverse is true. Our industry has literally begged postal personnel for years to put Periodicals on flat sorting equipment. We have made every change the Postal Service has asked for – including turning our mailing labels upside down – to ensure that Periodicals could be automated.

We believe that extensive manual processing survives because the Postal Service has not succeeded in reducing its workforce enough to match reduced processing needs. The costs of this excess capacity should not be charged to Periodicals and other similarly-situated classes – either directly because of unnecessary manual handling or indirectly because of increased overhead costs.

Periodicals Costs Are Overstated

The Postal Service's existing cost systems overstate the costs attributed to Periodicals. First, they assume that all costs are incurred efficiently, and that all worker time and other resources spent on processing a particular class of mail are needed by, and of benefit to, that mail. Charging periodicals for the extra costs of manual processing that periodical publishers did not request and do not need, is unjust and unreasonable. And it is inconsistent with the policy of the law that postal rates should reflect the costs of honest, economical and efficient operations.

Second, existing methods also overstate attributable costs by making unrealistic assumptions about the extent to which costs vary with changes in mail volume. For mail carrier costs, there is a general consensus that some of the costs are fixed (or institutional in postal parlance) in the short or medium run. For mail processing costs, however, the Postal Regulatory Commission has assumed for many years that virtually all costs are variable, and therefore should be attributed to individual mail classes. This assumption has led to protracted debate. For a decade in six different rate cases, the Postal Service tried to convince the Postal Rate Commission that mail processing costs were not fully variable and thus should not be fully attributed to classes. Several respected PhD economists demonstrated on behalf of the Postal Service that mail processing costs did not increase or decrease fully with volume, but had volume variability only in the range of 70-85 percent. Periodicals costs would look quite different if the Commission agreed that mail processing costs are not fully volume variable.

In FY 2009, Periodicals Likely Covered Short-Run Attributable Costs

In June 2009, the Postal Regulatory Commission approved the Postal Service's "summer sale" discounts for Standard Mail. In seeking the discounts, the Postal Service argued that the relevant measure of attributable costs for evaluating whether the discounted rates would cover costs was *short-run* attributable costs—the costs that varied with volume in the short-run during a period in which there was excess capacity—rather than long-run attributable costs, i.e., costs which assume a time period over which all excess capacity

has been shed. The Postal Service estimated that, because of excess capacity, the short-run attributable costs of the two Standard Mail categories with cost characteristics most similar to Periodicals were only 66% and 51% of their long-run attributable costs.

The same logic applies to the pricing of Periodicals mail. Although short-run attributable costs were not estimated for Periodicals Mail (because Periodicals Mail wasn't part of the "summer sale" case), Periodicals' short-run attributable costs probably were a similar percentage of their long-run attributable costs during the summer sale period. As shown in the chart above, the Postal Service's limited cost savings in 2009 suggest that excess capacity was present throughout the year. It is likely, therefore, that Periodicals Mail fully covered its short-run attributable costs—the proper measure of attributable costs during periods of excess capacity—in 2009 and made a positive contribution to Postal Service finances.

The Postal Service and Postal Regulatory Commission Continue to Examine These Issues

As I mentioned, in 1998, I participated in a joint USPS/Periodicals mailers task force to look at some of the issues I've addressed today. Twelve years later, many of the problems we identified are still unaddressed, and many of the questions we asked are still unresolved. The Postal Service and the Postal Regulatory Commission are currently looking at many of the same issues again. Their report is due within the next few months. Hopefully, this study will provide additional insights and recommendations.

The stakes are high for publishers and the Postal Service. Time Inc. and the other magazine publishers in the MPA plan to continue publishing our magazines for a long time to come. But we can achieve that only if postal rates for Periodicals remain affordable. An above-inflation increase while advertising is just beginning to recover from the recession could have devastating consequences. To answer the question posed in this hearing's title: Yes, the Price *is* Right. Periodicals and other non-letter shaped mail should not be asked to shoulder the burden of costs they did not cause. We stand ready to work with this Committee and Congress, the Administration, the Postal Service, and the Postal Regulatory Commission to find the right path forward for the Postal Service. Thank you for the opportunity to speak to you today.

Mr. LYNCH. Mr. Davison.

STATEMENT OF HAMILTON DAVISON

Mr. DAVISON. Thank you, Chairman Lynch. Thank you for your invitation to testify today. I represent the American Catalog Mailers Association. Half of America buys from catalogs, and for those who do buy from catalogs, when it arrives, it's arrival is something that's exciting and helps keep mail interesting and relevant to all—to the recipient.

Catalogs also provide significant social benefit delivering goods and services to the infirm, handicapped, elderly, and rural Americans, none of which can access stores easily. Catalogs are also eco-friendly. They may be America's biggest carpool. They save countless hours of driving and fuel and congestion on the road and are particularly helpful to single parent—time-starved single-parent families as well as dual-income households.

In 2006 Congress modified the ratemaking cost, but the cost accounting approach has not been modernized. The one that is in use today is a result of 36 years of intense litigation, and as far as I'm aware, has no parallel in any gap regulation or private industry standard cost system that is in widespread use.

Time doesn't permit me to delve deeply here, but I would say that the setting of prices and allocation of costs is an extremely complicated area that is properly placed with USPS management, with the review and concurrence of its regulator.

The USPS is a high-fixed-cost system that is operating below its available capacity, and as more volume leaves the system, the remaining fixed-cost base has to be spread over fewer and fewer pieces. Using a nonstandard justification to push prices up just further perpetuates that downward spiral. In fact, standard flats—the standard flats mail category was covering its costs until 2007 when there was an enormous increase in postage costs that drove a lot of catalogs to reduce their circulation. And further increases in this environment would be counterproductive and serve only to divert more catalogs out of the mail, put more companies at risk, and undermine the entire system.

I think there's some useful concepts in private industry. For almost every company there are products that the profitability of those products vary, and yet customers buy across many different categories. Companies regularly look at the sales in each customer's segment and try to understand the segment's profitability.

Applying this to catalogs, we mail in standard mail flats, but we also mail an almost equal proportion in carrier route, which generates a net contribution to the USPS.

We also, however, originate mail and standard mail letters, and standard mail postcards. We send profitable first class mail and we also spend almost as much on partial shipments as we do on sending catalogs, of which USPS is a relatively small market share there, and that provides an additional growth opportunity.

I think the key to the future survival of the Postal Service is to understand their total customer segment contribution. As illustrated above, taking decisions on a single product category can lead to changes in volume in other categories from that same customer segment. The goal must be increasing the total contribution from

each market segment by optimizing the price and volume relationship.

The greatest segment contribution is not always achieved by the highest price per piece. Sometimes a lower price which generates a maximum volume is one that is more profitable and sustainable. This is especially true in a volume-sensitive system with excess capacity.

A customer-segmented approach also allows USPS to manage the content of the mail stream, the amount of highly valued mail from the recipient's point of view.

With all the communications alternatives available today, it is critical to keep Americans engaged and interested in the mail. Managing the content does just that. Perhaps ironically just when the USPS is automating the flats mail stream, there are developments that threaten the amount of flats being processed. The USPS expects to dramatically reduce its cost to process flats with this equipment, but this will only occur if we do not drive flats out of the system before the automation comes on line.

So to summarize, the unique postal accounting system developed through years of litigation may not accurately reflect postal cost and certainly does not capture the market behavior of customer groups. The infrastructure of the USPS is hard to reduce and the system needs to retain and grow volume. The catalog industry, which is a significant demographic tail wind behind it, is a great segment for the USPS managers to be focusing on for long-term growth.

As catalog postage goes up, catalog volumes are going down. Since 1997 inflation has risen 37 percent, but catalog postage has gone up 58 percent, fundamentally altering the economics of cataloging, both reducing mail volumes and industry employment. In fact, the entire catalog supply chain remains severely strained from these large postal rate increases.

Thank you for the opportunity to testify, I will be happy to answer questions.

Mr. LYNCH. Thank you, sir.

[The prepared statement of Mr. Davison follows:]

TESTIMONY OF

HAMILTON DAVISON,

PRESIDENT & EXECUTIVE DIRECTOR,

AMERICAN CATALOG MAILERS ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE AND THE

DISTRICT OF COLUMBIA

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

U.S. HOUSE OF REPRESENTATIVES

MAY 12, 2010

Chairman Lynch, Ranking Member Chaffetz, Members of the Subcommittee, thank you for your invitation to testify before you. I represent the American Catalog Mailers Association or ACMA, a relatively new group owned and controlled by catalog marketers and their suppliers. While catalogers, with few exceptions, have not been particularly active in postal policy until recently, I am a long time student of postal affairs and am honored to be able to represent such a fine segment of the mailing industry.

Half of America buys from catalogs. For those who are active catalog shoppers, the catalog's arrival in the mail is an exciting event; one that helps keeps mail interesting and relevant. Catalogs also provide significant social and practical benefits by delivering goods and services to shut-ins, infirm, elderly, handicapped or rural citizens, none of which can access stores with any ease. Catalogs are also eco-friendly. In essence, they are America's biggest carpool; they relieve congestion and save both fuel and time. Catalog shopping is particularly helpful to time-starved single parent families and dual-income households.

When Congress first set up the Postal Service with the Postal Reorganization Act in 1970, it realized it did not want to be in the business of arbitrating postal rates. In its wisdom, it set up the Postal Rate Commission and defined a deliberately contentious process, similar to a full-blown litigation, where competing interests argue their case to get what they need from the government-sponsored monopoly. What developed over 36 years of intense litigation was a series of rate structures supported by a postal accounting system that, to my knowledge, has no parallel in either GAPP accounting or the private sector.

In 2006, Congress modified this cost-based rate-making system with instructions to the postal community to consider market conditions, efficiency, predictability, and value to sender and recipient. It was designed to grow volume, creating a financially-sound Postal Service. Congress also reaffirmed the content value of

what gets delivered each day with the continuing importance of the educational, cultural, scientific or informational value of mail.

While the Act is clear that products are to cover their costs "*through reliable causal relationships*," cost is now but one of many considerations. Moreover, the postal accounting system in use today was built through intense litigation. It is not the same as a standard cost system built using generally-accepted methods by operational and financial experts. Just as the rate-setting process has changed with the Postal Accountability and Enhancement Act of 2006, it is also time to change the cost accounting approach. Time does not permit me to delve deeply into these issues other than to note that the setting of prices and the allocation of costs is a complex issue properly placed with USPS management with the review and concurrence of its Regulator.

Today, we have an amalgam. We are not only on a necessarily long path to recognize market forces in pricing decisions, but we also still struggle with a legacy of cost-based rate setting. Old habits die hard.

Given the changing postal landscape, I would suggest that we consider a more accurate and more appropriate way of viewing things. Today, technology provides a variety of non-mail communication substitutes. This is particularly important in a high fixed cost system operating well below its available capacity. As more volume leaves the system, the cost on all remaining pieces goes up. Using a non-standard cost justification to push the prices up further just perpetuates the downward spiral.

The financial standing of the USPS makes it clear that it is time to do things differently. In fact, from my experience with turning businesses around I can conclude that when things are dire, it is exactly the time to stop doing the same things as they have always been done and instead press forward to innovate rapidly. With this must come an increased tolerance for making mistakes but it is

often riskier to not change at all. To my view, Congress and the postal regulator would do well to encourage the USPS to innovate at an accelerated pace, even recognizing that this means we will try some things that work, and some that don't.

Useful concepts can be found in private industry. For almost every company, the profitability of products varies and customers often buy in more than one product category. Companies regularly look at the totality of sales into each customer segment to calculate that segment's profitability. It is instructive to understand a customer's use of all products and the intertwined relationship between them.

Applying this to catalogs, we mail in Standard Mail flats, a product determined by traditional postal accounting methodology to be not covering its costs. However, catalog marketers also send catalogs in nearly equal proportions in Carrier Route rate bands, a product category clearly covering its costs and generating a net contribution to the USPS. From the customer perspective, these are inseparable as marketers send catalogs in both of these rate groupings in the very same mailing event. Actually, if one were to combine the two catalog rate categories in to a single service classification, the total would be net positive in contribution.

Catalogers also originate profitable Standard Mail letters and postcards. They also send considerable First Class Mail for things such as invoices and FTC required notification letters, among other communications. Even with widespread Internet use, catalog end consumers still return significant numbers of written orders via First Class mail. Meanwhile, catalog marketers spend nearly as much to ship packages to customers as they do to mail catalogs; the USPS share of this business is relatively minor, representing another opportunity for additional USPS revenue growth.

The key point of my entire testimony, and perhaps one of the most significant keys to the future survival of the Postal Service, centers around *the total*

customer segment contribution to operating the Postal Service. As illustrated above, taking decisions in a single product category can lead to changes in volumes in other categories from that same customer segment and thus affect the total financial standing of the entire system either positively or negatively, depending on how the customer segment is managed.

Given the complex commercial relationships across a diverse customer base, segmenting its customer portfolio into progressively finer and finer break-outs until homogeneous customer segments are achieved will allow the USPS to better understand the behavior of its customers and define where it adds value to each business relationship. With this knowledge, the USPS can increase the total contribution from each market segment by optimizing the price and volume relationship.

The greatest segment contribution is not always achieved by the highest price per piece. Sometimes a lower price, which generates maximum volume, is the one that is more profitable and sustainable. This is especially true in a volume-sensitive system with excess capacity. A customer-segmented approach also allows the USPS to manage the content proportion of the mail stream—the amount of highly valued mail from the recipient's point of view. With all the communications alternatives today, it is critical to keep Americans engaged and interested in mail. Managing the content in the mail does that.

Perhaps ironically, just when the USPS is automating the flats mail stream that there are developments that threaten the amount of flats being processed. The USPS expects to dramatically reduce its cost to process flats with this equipment. But this will only occur if we do not drive flats volumes out of the mail before automation comes on line.

In a similar way, we must resist the temptation to have Congress function as a 538-person board of directors for the USPS. We already have a structure for

appropriate supervision of the Postal Service. USPS managers should be responsible for running their business. The Board of Governors should provide oversight. The Postal Regulatory Commission should provide checks and balances to a government-sponsored agency with what are effective monopoly powers. Congress should allow this established mechanism to do the heavy lifting unless it is clear the structure is breaking down. A time of crisis is exactly when stakeholders should support its management team, not second-guess it, unless the crisis is determined to be of their making. An economically-driven volume decline is not. On the other hand, improper pricing of products that drives industries out of business, improperly encroaching on the private sector using the massive resources of government, or discriminating against interests that cannot protect themselves are all appropriate areas Congress can act on if there is a breakdown in the total established postal policy apparatus.

Summary:

A unique postal accounting system developed through years of litigation may not accurately reflect postal costs and certainly does not capture market behavior of customer groups.
It is clear that cost is now only one of many determinants to making postal product pricing decisions.

It is clear that the infrastructure of the USPS is very hard to reduce and that the system needs to retain and grow volume. It is also clear that the catalog industry, which has a significant demographic tailwind behind it, is a great segment for USPS managers to focus on for long-term, sustainable growth.

It is also clear that as catalog postage goes up, catalog volumes are going down. The rapid and dramatic change to catalog postage costs in 2007 (as a result of the R2006-1 rate case) fundamentally altered the economics of this industry segment, reducing its mail volumes. In fact the entire catalog supply chain

remains severely strained from these large postal rate hike catalogs so that even today, three years later, many catalog companies are still trying to reduce their use of mail.

In a high-fixed-cost system, as units leave the mail, the fixed-cost load must be spread over fewer units. This is significantly increasing the cost of catalogs. In fact, the Standard Mail flats category was covering its costs until the 2007 increase triggered a dramatic reduction to catalog circulations.

Now is precisely the time to abandon approaches that no longer serve us. We must truly move to a market-based postal system if we are to have a sustainable agency, for without these postal customers, the one's that provide over 90% of the cost of running a national post, the cost of universal service as well as all the future obligations of the USPS will necessarily become an added burden to the taxpayer. This is obviously something none of us want or need.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions you may have.

Mr. LYNCH. I now yield myself 5 minutes.

President Burrus, I know that in my early days on this committee, you've been an energetic advocate of, I guess, right-pricing the costs of these items that don't necessarily cover their actual delivery costs. And you've pointed out that's a real flaw in the current system. And if I read your testimony correctly, it states that first class single-piece mail makes a larger contribution to the overall institutional costs than its workshared counterpart. And I just wanted to hear your views on whether or not you can explain that, why that is occurring.

And No. 2, is it right to try to assign at least the attributable cost of each piece of mail that goes through the system or, as Mr. Davison has sort of insinuated or argued, that you should look at the carriers' costs across various products.

Mr. BURRUS. The problem with—my mic is on isn't it?

Mr. LYNCH. It is, yeah.

Mr. BURRUS. The problem with the attributable cost is that—and I've heard several witnesses respond to questions regarding it—is it takes the resulting contribution, the discounted rate, and from that they assign it attributable cost. APW's argument is it's a discounted rate, it is too steep, that the discounted rate should be higher than it is, then the attributable cost goes up, setting aside for a moment the percentages between nonattributable and attributable.

But if the mailer is paying for the piece, then the contribution to the attributable, the institutional cost is increased. Our argument is that the discount is set too high. They are paying—postage rates are too low.

It is really disturbing to me to hear witness after witness talk about the success of the program, and the Postal Service is projecting a $7 billion loss.

Now, how can you forego—forgive over $1 billion a year in discounted rates and lose $7 billion? It just defies logic. It is like we're living in a different land; there are different economics that apply to the Postal Service that don't apply in the supermarket or someplace else in our society.

The real assault on the U.S. Postal Service and its work force is when you set a discount at the cost avoided, and you take mailer out of the system, the mail that's lost—that is left, that is avoided, is more expensive. We have to have a network that serves the Aunt Minnies of the world, the single piece. Now if we have a major business in the community, then the volume is high and Aunt Minnie's mail is incorporated, integrated with all other mail, so the cost is reduced. Once you take all the other mail out of the system and presort it, apply workshare discount, you leave Aunt Minnie's mail, singular, like the flats that were mentioned, you leave only the most difficult mail in the system and the cost automatically goes up. And that is the standard they use to determine the cost avoided, what they leave the U.S. Postal Service.

This entire workshare-discounted program has turned the rate structure of the Postal Service on its head. It is not generating volume consistent with the work that is performed because they are charging deflated costs for the same work.

I attached to my testimony two examples, of two letters, one where the rate paid was 42 cents, the other 34 cents, an 8-cent difference for that letter, and the indicia on the envelope were exactly the same; meaning they were handled the exact same by the U.S. Postal Service, including delivery.

The Postal Service cannot exist if they are setting up a companion system in the private sector to perform the exact same purpose, the same functions. They will spin off sufficient revenue that cannot exist long term.

Mr. LYNCH. Thank you. I know my time has just about expired. The chair recognizes the gentlelady from the District of Columbia, Ms. Eleanor Holmes Norton, for 5 minutes.

Ms. NORTON. Thank you, Mr. Chairman. I thank you for yet another hearing on what I must say is a failing, if not obsolete, model known as the U.S. Postal Service. And I think your hearings on various aspects will lead us to where Postal Service isn't—certainly isn't leading us to where I think some hard decisions have to be made.

For me, I must say this is a straight mathematical, if not arithmetical, exercise. If there are savings, if they are worth it, then there is a discount; if not, it's not. And I don't see why it is more complicated than that, especially considering the urgencies surrounding the financial conditions of the Postal Service, albeit with slight improvements that really don't matter because the model is failing in any case.

Work-sharing is like the rest of the post office. It may have made some sense long ago when it was instituted, when automation was not the way in which the Postal Service operated, with less and less manpower of its own. But if the whole point is to modernize the service, if you get a model that works, I don't know why we would stick to this part of the model unless it can justify itself.

I'm sorry I was not here to hear the testimony. I don't know if anyone has tried to justify the model. I was presiding in the Committee of the Whole on the floor, but I would be very interested to hear what justifications for the model exists in dollars and cents frankly, count it out. I mean, you know, there are harder—harder issues to figure out in the Postal Service that do not lend themselves to the same kind of numerical equation that I think could be done here.

What most concerned me is, is there a cost to individuals in small businesses? That simply cannot be tolerated. And there is some testimony, as I look through the testimony, that indicates that may be the case.

Look, if we all want to use this model, we're all going to have to do something very different from what's been done before. Eighty percent, or something like 70 or 80 percent of the American people in polls say, OK, eliminate Saturday delivery. Saturday delivery is a fairly recent phenomenon of recent decades, but I'm not sure what it will take to get that change, if that change is to occur.

But the notion that we're sitting with the same model we've been having hearings about, I must tell you is very troubling to me, which is why I am pleased the chairman has chosen this aspect to consider here today.

The fact that—I was not aware until this hearing that work-sharing was almost all that occurs in the Postal Service these days. It has taken over the Postal Service; 80 percent of the mail is work-shared. So little has changed about the Postal Service.

Mr. Chairman, I haven't been here long enough to ask truly intelligent questions. I simply want to go on record as saying I think the Postal Service has to be pressed much harder not to do what it's been doing, saving here and there around the edges. We're delaying the inevitable. It's just too late to do that. We have simply got to fish or cut bait. This model doesn't work.

I don't know if enough people, Mr. Burrus, are going to retire in order to help the situation involving personnel. I don't know if they will make decisions about work-sharing. I don't know if they are going to quickly get to a recommendation on 5 or 5½-day mail. All I know is it's going much too slowly to save the Postal Service. And above all, I want to urge greater efficiency, as it were, on the part of the Postal Service in getting themselves a brand new model and coming before this committee to share it with us.

Thank you very much, Mr. Chairman.

Mr. LYNCH. I thank the gentlelady.

Mr. Buc, let me ask you, the Postal Regulatory Commission's most recent annual compliance determination revealed that, I think, 30 workshare discounts exceeded their—their avoided costs; seventeen of them were justified under statutory exceptions, but 13 were not justified.

Have you had an opportunity to review that, you know, those—at least the cases that were brought forward? And do you think that the PRC's determination was justified or do you take exception to that?

Mr. BUC. I haven't reviewed each and every one of them in great detail. The PR—the Postal Regulatory Commission is the umpire in this world that calls the balls and strikes. We may argue with him occasionally, but most of us defer to them in judgments like this. Again, my testimony is that, in general, discounts should be equal to costs avoided. I don't believe that they should be less. I also do believe, in general, that they should be more.

Mr. LYNCH. How do we—well, they found—they found differences here that we had departed from the ideal of matching the discount to the attributable cost. And so now they are struggling, as you heard at the previous panel, struggling to meet the goal of aligning the cost with the charges. And I know that you're concerned about that.

Do you have any suggestions as to how they might align those costs without causing undue damage, or perhaps less damage, than otherwise might through this exigent rate case?

Mr. BUC. It's a very, very hard question. You ask many people the same question. In the long run, it can't be the case that all products sell below their cost. You simply can't do that in the long run.

But in a situation where costs are above price, there are actually two possibilities to get things lined up. One possibility is that you can reduce costs to be where the prices are. Mr. O'Brien has spoken about the flats world, where perhaps some things could go on that would take care of that. The other possibility is that you

would raise prices to cover some of those costs. And the Postal Service needs to be careful that it doesn't drive volume away. As you all know, in the world today, mailers have lots of alternatives.

Ms. Robinson testified the choice is not between work-sharing and not work-sharing for many mailers. It is between mailing at all and not mailing. So the Postal Service has a really tough problem. If I had the solution, I would actually give it to them.

Mr. LYNCH. Thank you. Part of this, we're confronting this in a very difficult time. A rising tide lifts all boats, and in this case the tide has gone out and so every sharp rock, every shoal is now exposed, and so we're trying to meet that challenge. It is a very difficult situation. And I understand for every reaction we take care to try to—to try to align costs with—align charges with the costs that those deliveries incur, we risk losing that volume of mail, which is exacerbating the situation. So we're between a rock and a hard place here. And we're trying to, I think, manage the current situation with the idea that if volume picks up, if we gain a fair amount of the market share and the volume that we've lost, that we can live to fight another day. I'm just trying to find out from the mailing community what that looks like. What can we sustain going forward without causing us greater harm?

Mr. BUC. We actually have some optimism about some of the volume coming back in standard mail, marketing mail. Through the recession the Postal Service has actually kept its market share and increased its market share a little bit. So as the economy recovers, we're very optimistic that there will be more marketing mail.

In first class mail, the prospects are not quite as optimistic. It turns out that historically every time the Postal Service has granted a new work-sharing discount, people have found new ways to use mail. And I do believe that's been responsible for much of the growth of postal volume over the years. There are some opportunities for additional work-sharing discounts that the Postal Service might think about availing itself of.

Mr. LYNCH. Thank you.

Ms. Eleanor Holmes Norton, you're recognized for 5 minutes.

Ms. NORTON. No. No further questions, Mr. Chairman.

Mr. LYNCH. Thank you.

Dr. Riley, you went a little bit afield from your original testimony, but it was interesting nonetheless. I know you got away from the pricing question and spoke a little bit about the 5-day delivery question. And my own concern is this: that if we somehow eliminated Saturdays, then I actually think it puts us in a more difficult financial situation with the Postal Service. We would lose not only the Saturday delivery and that revenue, but I also think that customers may say, well, if they've got mail that's going out on Thursday, or—you know, or Friday, they'll say, Well, you know, the post office—not the post office—but there will be no delivery on Saturday and Sunday. If there is a holiday on Monday, maybe I ought to call USPS or FedEx or someone else, so there will be a migration of mail volume that is currently relied upon by the Postal Service to sustain its operations so that, at the end of the day, it's a self-inflicted wound. It doesn't make the Postal Service stronger, it actually may make it weaker, and considerably so.

I'd just like to hear what your thoughts are. I know you've talked about that in your original testimony, but I would like to hear your thoughts on that.

Mr. RILEY. I think—am I on—I think you're precisely right. Congresswoman Norton talked about the business model being broken, and the business model is broken because people chose to break it. Saturday delivery, I think the Postal Service says that 71 percent of the people say they don't care, which means 29 percent of the people do care. Why do you want to anger 29 percent of your customers and drive them away, to finally give up and say, you know, I've had it, I'm going electronic. It makes no business sense.

I can't think of one service organization in this country that looks to prosper by cutting back on its service. If you go to the FedEx Kinkos in Herndon, VA, which I did to get the charts printed up so you could see them, you'll discover they are open 24 hours a day, 7 days a week.

Service businesses are in business to provide service, and the Postal Service has gotten away from that. In general terms, the Postal Service raised the price of a first class stamp 37 percent since 1998. Over that time, inflation has only gone up 33 percent. It has gotten rid of 20 percent of the work force and it is sill losing money. It should be coining money and it is not, because it is driving customers away for some of the smaller self-inflicting wounds.

And Chairman Lynch, you're exactly right; this would be a huge self-inflicting wound. And I believe the Postal Service will not recover if it is allowed to proceed with that. Not that I feel passionately, you see. I have devoted most of my life to the Postal Service.

Mr. LYNCH. I still have some time left.

Mr. RILEY. Sorry.

Mr. LYNCH. What about the idea—I know a lot of e-mail is just person to person, so that's probably not as big an impact on the Postal Service, because they weren't necessarily writing letters to each other, and that wasn't volume that was eliminated. But I do know that it is quite common now, even myself paying bills by mail—excuse me, by the Internet and on line, and there is a huge volume of mailers disappearing.

And so I think it is irrefutable that we're going to a new model here. And I don't know, you know, you're much more familiar with this in your teachings and in your studies than I am, but at least the anecdotal evidence I see is fairly powerful.

Mr. RILEY. I converted last summer to paying bills electronically because I couldn't get my mail sent to where I was. And that's because I was going to be in different spots in the country at different times. And I was willing to pay $15 a week for Snowbird mail to put it all in a priority mailbox and send it to me. It would only go to one address, and I could only choose one at a time and I had to specify the dates in advance.

In a world where I can go online to every one of my credit cards and change my bill once a month with a password-protected device, I can't get my mail sent to where I'm at. So my solution was to pay my bills on line.

The Postal Service—if everybody in this country knew about Snowbird mail—and there are 38 million retired people in this—38 million people over 65. And if that's—if just 5 million of them

were to use 10 weeks of Snowbird mail, that would add $750 million in revenue and the cost would stay the same, because the Postal Service is already forwarding most of that mail piece by piece anyway. It's more efficient to put it in a box and send it out.

So there are a lot of good things the Postal Service could do to change the business model to take into account what's going on in this era. My daughter has been paying her bills on line forever, worried about identity theft and thinking about moving back. Does anybody ever advertise the Postal Inspection Service and say that mail fraud is still a crime and 96 percent of the people charged with mail fraud get convicted? Try getting somebody convicted for mail fraud over the Internet.

I think there's a great business model that could happen that is being ignored. I think your instincts are right on.

Mr. BURRUS. Mr. Chairman, I think there is a misconception that postal volume is driven by personal communications. A lot of personal communications has migrated through electronics, Internet, Tweeters, telephone and other. That is a very small percent of total volume. Postal Service volume is driven by commercial mail. I get more mail today, even with the decline, major decline of volume. I get more mail in a month than my father received in his entire lifetime. So there is no connection between growth of volume. In 2006, the Internet did not go on vacation; we reached our highest point of hard-copy communications in this country, in the world, in 2006.

Mail is tied to commerce. As the economy grows, mail volume will grow. This side show of individuals sending birthday cards on the Net, certainly we would like to have all the mail, we would like every message to be converted to hard copy, but we can grow without it. The Postal Service is an advertising company. They have to understand and appreciate the fact that they have to grow. Their growth will be in commercial mail, letter mail, not in parcels. It will be in letter mail.

And if they fail to capture a growing market in letter mail, they can't exist in niche services.

Mr. LYNCH. Thank you. I think the truth is somewhere in between here, that all this mail is not going to go away. I think a lot of mail is going to come back with the economy and advertising.

I also know there are technologies out there. I know—I think it is Sweden or Finland, where you can go on line and actually see your mail before it's delivered, and click on it if you want it delivered and, I guess, dispose of it if you don't want it delivered. And I think as that greater sort of interaction with the customer becomes more commonplace, I think we have to recognize that technology will be out there. So we're trying to provide—we're trying to reconstruct a system and modernize it so that it stays current and that we don't fall behind. You don't become the buggy-whip of the next century.

We have the same problem here in Congress. We got rid of the powdered wigs, but that's about it. We're still operating the same way we did back in the 1700's and we're trying to keep up with modern industries that are running circles around us.

Mr. O'Brien, I think it was you, in October 2007—it is terrible to come here and testify, because we can always throw your testi-

mony in front of you at a later date—but you testified before the subcommittee in favor of a recently redesigned rate structure to better align rates and costs for periodicals. Now several years after that rate structure has been in effect, do you think that the newer rate structure has been a success?

Mr. O'BRIEN. Yes, the rate structure actually has caused a great deal of change. As I said in my testimony today, we used to only produce 29 percent—the periodicals volume came in carrier route bundles, the most efficient bundle we can give them. Today that's over 55 percent. Without that rate structure, we would not have incented that change. And that just improves the process.

So the other thing that you should know is this carrier route bundle, the pass-through of cost savings is 71½ percent. So this is not one of those underwater products that you've asked about earlier today. So if the Postal Service saves a dollar, 71½ cents is what the incentive would be for the mailers. So this is a good deal for the Postal Service.

Mr. LYNCH. All right. In your testimony before, at least part of it, you described the inefficiency with periodicals in that they were manually processed as something that was undesired and unnecessary on the part of the mailer. Can you flesh that out a little bit for me?

Mr. O'BRIEN. Sure. Basically the Postal Service has spent billions of dollars on automation. And when you automate a process, you sometimes wind up with excess capacity and you need to have that excess capacity utilized in some way; otherwise people are standing around. And so what happens is things get created, like these bull pens, which are basically hampers that are all lined up in a circle, and people come and take bundles and throw them in these hampers designated to various zip codes in an area.

And so that manual processing exists today. I saw it 3 weeks ago. I see it in every SCF that I go into, Section Center Facility that I go into, it exists today. After spending billions of dollars on machinery, they have to find a way to capture those savings and not do manual processing of mail today. I mean, it's a complete—complete waste of time and it exacerbates the cost for periodicals mailers. We just can't have that happen.

Mr. LYNCH. I'm trying to get these straight in my mind. Is that flat sequencing system? Is that——

Mr. O'BRIEN. It's not even that. There's—there are machines today that will sort bundles and just like this, and so instead of sorting the bundles on the machine, they're sorted by hand, and that's just insane. The machines exist today, but the Postal Service segregates periodicals out, puts us on manual processing.

And the way that they track costs is something called the IOCS, which is an in-office cost system, and the way it works is like this: It stopped the music. So they stopped the music and say, what are you holding? I'm holding—I'm holding periodicals. I'm charged to periodicals. Mr. Riley's holding a catalog. He gets charged to catalogs. Well, if you automate a process, and you put manual labor on a certain class of mail, when you stop the music, more bodies are holding magazines, and we are attributed with the costs. It's not right.

Mr. LYNCH. OK. Thank you.

Mr. Davison, I did recall in your testimony you didn't really discuss this, you talked around it, but the flats sequencing system and its potential effects on improving the costing of catalogs. Do you think this FSS, this flats sequencing system, has promise to address some of the concerns that you raised in your testimony?

Mr. DAVISON. I think it has the potential to lower the cost of processing catalogs and magazines, and we only have nine machines out today, and they haven't even been fully accepted; so that's a little bit of an unwritten story still. But I have, as Mr. O'Brien describes, also been in facilities and seen the inefficiency in the processing of flat mail, and we very much need something that will automate that and allow it to be handled more efficiently. I mean, as was said by, I believe, Mr. Waller, the costs in this category have been very high and out of control. We've had a 58 percent increase in postage in a 34 percent inflation period. So we're much higher than inflation. It's just not sustainable from our perspective. So we've got to—we've got to go after the cost side.

Mr. LYNCH. Where are we in that process? You said there are nine locations that have these, and where are we going, as far as you know, with full implementation? Has this been stalled, or why is it not more widespread?

Mr. DAVISON. I can't—I can't answer the question for the Postal Service. I know they're working very aggressively on it. I know they've been working with us and others in looking how they can get mail to the front of the machine most effectively and induct it into the machine automatically. They've propagated a number of changes to the regulations to allow some of those things to occur.

It's my understanding that they're still completely committed to it, and at the same time you do have flats volumes that are dropping. So it's a little bit of a moving target. Where do you put the machines, and what is the cost justification of them when you have so much volume leaving the system? It's—we're doing things to ourself in our pricing that's driving volume out rather than keep the volume in and lower the cost basis through automation, which seems to be a much more sensible approach.

Mr. LYNCH. Let me put a question out there for Mr. Buc and Mr. O'Brien and Mr. Davison. The pending rate case there, the exigent rate case that they plan to introduce in 2011, what are your major concerns with—they've indicated a moderate increase. Do you have any sense of what that means? I mean, we tried to elicit from the earlier panel what that might actually constitute, but you might have a better idea.

Mr. BUC. As you know, the Postal Service says that its Board of Governors speak for them; so I wouldn't want to speak for their Board of Governors. But the rumors on the street, and, of course, there are rumors on the street, is that moderate means under 10 percent and perhaps well under 10 percent. If you go read the trade press, you'll see that the trade press is reporting 5 percent for products that are covering their costs, 8 percent, 7 percent, 9 percent for products that are—I mean, that's all over the trade press. So that's not my number; that's trade press numbers.

Mr. LYNCH. Is that what you're hearing, Mr. O'Brien and Mr. Davison?

Mr. O'BRIEN. Yes. I think that's—that's very accurate. But the one point I'd like to make on that is they're talking about a higher-than-average increase for periodicals class and standard mail, which is the catalogrs. And the point that I'd like to make is before you do that, make sure that you get the costs right. You know, people don't object to covering their costs, but they just want to make sure that the costs are right. Everyone should cover their costs for sure, but just make sure that your costs are right before you arbitrarily increase someone's rates.

Mr. LYNCH. Right.

Mr. DAVISON. And I'd—I'd just add to that you have to consider where we are right now. We've just come through a very terrible recession, and the whole system is strained. There's just not a lot of ability to absorb large increases, and we are in a zero or near zero inflationary environment, and this is a time when jobs are very important. There's a lot on the line here.

Mr. LYNCH. I appreciate it, and we spoke to that earlier about the fragile nature of the Postal Service, so we don't want to introduce any unnecessary shock, but we certainly do want to bring those products up to a point where they're closer to covering their entire cost. I mean, you can bring it up gradually over time hopefully, but I understand the vulnerability is heightened right now.

Mr. DAVISON. When I ran a retail business, we would have products that weren't making the average markup, but we would use those to get people in the store and buy other products. And almost every business I'm familiar with has a variability between products of the profitability, and I would respectfully suggest we shouldn't look at the product profitability, we should look at the customer segment profitability and figure out how customers are using the service and what incents them to buy so that we can continue to add value in that relationship and develop new products based on our keen understanding of their unique needs that aren't being fulfilled today. And I kind of concur with Dr. Riley on that point. To the extent that you understand customer behavior, you can deliver products that they don't even know they need based on that understanding.

Mr. LYNCH. OK. Well, I want to thank you all for your willingness to come to the committee today and help us with our work.

I'm going to leave the record open for 5 legislative days for Members to submit questions, if they have any, for you or for the first panel.

And with that I will declare this hearing adjourned. Thank you.

[Whereupon, at 5:10 p.m., the subcommittee was adjourned.]

[The prepared statement of Hon. Dennis J. Kucinich and additional information submitted for the hearing record follow:]

Statement of Congressman Dennis J. Kucinich
May 12, 2010
Committee on Oversight and Government Reform
Subcommittee on Federal Workforce, Postal Service, and the District of Columbia
"The Price is Right, or is it? An Examination of USPS Workshare Discounts and Products that Do Not Cover Their Costs."

I am an ardent supporter of the Postal Service and I recognize its importance to our local communities. I have a strong commitment to, and interest in, ensuring its financial viability. Constituents in my district continue to relay their concern that their local post office branch will be closed. United States Postal Service (USPS) employees and the general public have also expressed strong opposition to many of the proposals the Postal Service has presented to save money, such as eliminating 6-day delivery.

Each time this subcommittee meets to discuss ways to maintain the viability of the Postal Service, serious questions are raised about Postal Service management operating in a manner that is counterproductive to addressing the dire financial circumstance USPS finds itself in. At a time when the Postal Service posted billions of dollars in losses just this year, the Postal Regulatory Commission (PRC) found that 30 types of worksharing discounts sustained costs to the Postal Service that exceeded the postal costs avoided. This resulted in the loss of significantly needed revenue for the Postal Service.

I stand ready to work with all stakeholders, including Postal Service management, to ensure the viability of USPS. At the same time, I am gravely concerned that many of the proposals to stem losses focus on the costs of maintaining its

invaluable workforce that carry out its mission to provide people across the United States with universal service. Cutting six-day delivery, work hours and consolidating post office branches may appear to be a cost-saving measure now, but what happens when the economy recovers? Will local post offices still be there to serve the local community? I strongly believe that the Postal Service should instead examine ways to provide services and training for its employees that would allow it to more effectively compete with UPS and Federal Express.

Questions for Dr. Michael J. Riley

Your testimony echoes my concern that much of the Postal Service's proposals for a healthy USPS focus on cost reduction through cuts in essential services, rather than addressing current policies that result in the loss of desperately needed revenue. PRC Chairwoman Ruth Goldway and national postal worker unions have also expressed this concern. They have provided excellent ideas for revenue generation that warrant further examination. Examples of those proposals include providing government services at local post offices, providing retailers a space to sell their services or products, implementing a vote-by-mail system, and having a range of products that are trackable and traceable to compare with private companies that provide that service. **You provide some of your own ideas to increase mail volume, and as a result, revenue. Your proposals pertain specifically to mail products, while previous discussions in this Subcommittee pertain to revenue-generation ideas outside of USPS' historical mission. Have you considered the viability of the revenue-generation methods that have been proposed, that include the ones I just mentioned? Which proposals do you believe have the most promise, and why?**

National Newspaper Association
Washington Office
PO Box 5737
Arlington, VA 22205
703.237.9801
Fax: 703.237.9808
Web Site: www.nna.org

May 12, 2010

The Honorable Stephen Lynch
Chairman
Subcommittee on the Federal Workforce, Postal Service and the District of Columbia
B349-A Rayburn House Office Building
Washington, DC 20515

Dear Mr. Lynch:

On behalf of the National Newspaper Association, a 125-year old organization representing 2,000 members that publish community newspapers, we offer some observations and concerns for the record of the subcommittee's May 12 hearing on work-sharing discounts and "under-water" mail classes.

NNA's members include weekly and small daily newspapers across the United States, most of which depend heavily upon the mail for distribution. Most of our member newspapers have no private carrier force; even many of the daily newspapers increasingly rely upon USPS for delivery. The Within-County periodicals mail subclass is dominated by these newspapers. Eligibility to use this mailing subclass, which has received no federal subsidy since 1994, is restricted by Congress to newspapers with circulations under 10,000 or whose distribution is primarily within its county of publication.

NNA works closely with other members of the Periodicals community on public policy, mail preparation and service issues common to all Periodicals. Indeed, newspapers are also heavy users of Outside County Periodicals mail to reach readers within their markets but outside county lines, as well as those further away—such as students and snowbirds. However, the larger Periodicals mailers cannot speak for Nna or the Within County mailers. The Within County subclass is known to be NNA's primary concern, and the organization freely offers its counsel on this subclass to the Postal Service, the Postal Regulatory Commission and members of the Congressional oversight committees. We have appreciated the support of Congress over the years for maintaining this important subclass, which stems from an act of Congress in 1851.

Within County mail must be analyzed separately from the Outside County dominant subclass within Periodicals. Although both subclasses are formally "under-water" according to USPS statistics, there is reason to be skeptical of the perception that Within County mail is being subsidized. There are several reasons for this skepticism:

1. According to the Postal Service's most recently filed Billing Determinants covering the first quarter of Fiscal Year 2010, this mail is highly presorted. The report indicates that 81% of this mail is sorted by publishers to the carrier route and over half of the mail is transported by publishers directly to the delivery post office. Unlike Outside County Periodicals that require greater transportation and mail processing costs, the Within County newspaper mail requires only minor sorting—almost all performed at the carrier station, or even at the mailbox—and very little transportation. Some walk-sequenced mail can be delivered as a third bundle, and does not even require casing by the carrier. If mail processing costs are the root of the Postal Service's concerns over below-cost mail, this subclass is highly unlikely to be a part of the pool of problems.

2. The Postal Service has opined that a part of the problem in Outside County Periodicals derives from a shrinking advertising base. Because the complex postage calculation for Outside County mail involves a higher rate for advertising pounds of mail than for editorial pounds of mail, shrinkage of advertising in magazines and newspapers may play a role in concomitantly shrinking postage. But the Within County rate is calculated only by pieces and pounds, with some adjustments for work sharing by publishers. A growing editorial share or a shrinking advertising share in a publication would play no role in the postage bill.

3. The small size of this subclass—although a critical one to community journalism—is problematic for the Postal Service. It represents less than a half of one percent of the market dominant classes total mail volume and a little over 10 percent of the total Periodicals mail volume. As a result, when costs are calculated, USPS relies upon estimates and proxies in several of its key costing segments. It finds in its cost-sampling systems that Within County mail pieces are simply not detected often enough for high reliability of cost estimates. Similarly, because much of the Within County mail volume appears in rural areas, where the automated Postal One accounting and management systems have not yet reached all post offices, USPS relies upon statistical samplings of small post offices to calculate mail volumes. In the most recent cost-of-service omnibus rate case, the PRC required the Postal Service to average several years of volume to come up with a more accurate mail count. PRC has also on numerous occasions requested better statistical data for this subclass, and has reported to Congress on unreliability of data for the smaller subclasses. Thus, while there may be problems with the true cost of this mail, an inability by the best of experts to reliably identify the true cost of this mail makes reports of concerns somewhat suspect.

4. Oddly enough, in an age where the Postal Service fears massive losses of volumes, this small subclass has played a part in providing growth. In Fiscal Year 2008, Within County mail actually grew 12.8 per cent, then another 3.4 percent in 2009 while total Periodicals mail fell 8.7 percent. The first quarter of FY 2010 reaffirms the trend: Within County Mail was up 1.6 percent while Outside County fell 11.4%. NNA believes much of this growth derives from the conversion of small daily newspapers from private carriers to the Postal Service. NNA notes that this conversion will be reversed if USPS drops Saturday mail delivery, as daily newspapers will once again be required to form private carrier forces.

5. Finally, during recent meetings with USPS over the problems of "under- water" Periodicals mail, we were told that while Periodicals costs rose about 7.4 percent in the latest fiscal year, about 7 percent of that cost increase was simply from the combined wage and cost of living increases of the employees' contracts. If that is the case, the situation appears to be more one of the revenue of mailers being unable to keep up with planned labor increases that were obviously set in a very different economic era. One would hope that with the Postal Service's attention to costs in the coming years, small mailers like NNA's members will confront a more contained human resource cost. Certainly in an industry like newspapers, which have sustained layoffs, furloughs and downsizing in tight years, the prospect of ever-rising human resource costs in distribution is disturbing.

NNA appreciates this opportunity to comment and looks forward to working with you and the subcommittee in the coming months, as the critical questions facing the Postal Service are considered.

Sincerely,

Max Heath
Shelbyville, KY
Chairman, NNA Postal Committee

Tonda F. Rush
NNA Washington Office/Arlington VA
Director of Public Policy

The American Catalog Experience:
Catalog Marketing's Social Importance to American Consumers & Culture

Catalogs Bring *A Variety of Good* to Americans

Overview

The catalog industry has a wide-sweeping impact on American culture, well beyond the economic benefits of employing millions of people, paying millions in federal, state and local taxes, and conserving energy and natural resources. The American catalog experience has significant and important social benefits to American culture and consumers.

Catalogs are Good for American Consumers and Our Quality of Life

- Catalog shopping is convenient and available 24/7/365 from one location accessed by mail, telephone or online. Oil consumption, traffic congestion, and parking are not factors.
- Catalog shopping is unconstrained by geography, thus eliminating physical and distance boundaries. Catalogs put a world of products in the hands of Americans.
- Catalogs allow instant service whenever and wherever people wish to shop. They are accessed anywhere, home or business.
- Catalogs define "universal access" for merchandise and commerce.
- Catalog shoppers consistently report it is easier to get detailed product knowlege and excellent customer service over the phone than elsewhere (or even to find a sales associate). There is usually no or little waiting time to get help.
- Catalogs fight the homogenization of products driven by retail consolidation ("the Wal-Mart-ization of America"). Retail economics force aggressive rationalization of merchandise assortment. If retailers do not sell a high number of pieces per individual store, they cannot exist. If catalogers, who usually offer a much broader assortment, do not sell a high number of pieces nationwide, they cannot exist. Retail and catalog are different business models and both are important for the growth of the American economy.
- Catalogs create an easy way to comparison shop without necessitating multiple trips to different stores.
- Catalogs make sending a birthday, holiday or special occasion present to anyone, anywhere a convenient pleasure, helping Americans stay connected in an increasingly mobile society.
- Catalogs allow people to shop for potentially embarrassing products in the privacy of their own home without worrying about being out in public — for instance, a cancer patient buying a wig, or consumers buying unusual or plus-sized clothing in the privacy of their home rather than in public at stores. Personal hygiene, medical and disability-related products are frequently purchased from catalogs for enhanced privacy.
- Some of the specialty products sold by catalogs includes diabetes-related products, organic products, business productivity tools, pharmaceuticals, and other specialized goods for which a ready retail market might not otherwise exist.
- Catalogs contribute to the quality of life by providing a convenient, fun, compelling leisure time experience. Recreational shopping is an important pastime for many Americans.
- Catalogs remain part of a shared experience in America that remains relevant, human and enjoyable in the increasingly impersonal age of ecommerce and electronic media.

- Catalogs form part of our collective experience. Who doesn't remember the childhood pleasure of paging through the often-remembered Sears Wishbook catalog?

Catalogs are Good for the Environment

- Catalogs may be America's biggest carpool.
- Catalogs have a low carbon footprint and are becoming more environmentally friendly every year. Yes, catalogs use paper, but the modern advances in forestry management have made trees a sustainable crop. In fact, there are more trees in North America today than there were at the time of Columbus's voyage. Plus, advances in the recycling of paper continue to develop and it takes 60% less water and energy to make recycled paper than to break lignin into virgin fiber. Please see www.catalogmailers.org for more information on «Catalogs and the Environment».
- Catalogs make the phone ring, a nearly environmentally neutral communications method in a society increasingly aware about ways to cut our carbon footprint.
- With very few exceptions, catalog companies demonstrate responsible mailing practices, honoring consumer demands concerning mailing frequency, contact methods, and individual consumer needs and wishes. Catalogers are, by the precise and stringent economics of cataloging, self-regulating, and cannot afford to do otherwise.

Catalogs are Good for the Economy

- Catalogs stimulate consumer demand, both for direct and retail, fuelling the largest engine of economic activity we have.
- Catalogs are highly targeted and merchandised to meet specific consumer interests and needs, thus representing an effective and efficient marketing channel to maintain and strengthen American competitiveness.
- Catalog brands have a long-term relationship with Americans that is part of the shared American experience. The ability to come back to trusted brands and companies for the things we need, knowing the consistency and helpfulness we will find as consumers can be relied upon again and again. This is a high ideal of American commerce.
- The robust American catalog shopping expereince allows for a shift in power from the retailer to the consumer.
- Catalogs are mailed predominately to willing customers who may have a pre-existing relationship with retailers, or to those consumers who have requested a catalog from a company they are interested in shopping with, or to other "opted-in" consumers who have expressed interest in receiving marketing information or specific offers.
- Catalogs help small businesses succeed.

Catalogs Encourage Small Business

- Catalogs allow many small businesses to quickly and efficiently access specialized products that keep them competitive despite their niche focus, small scale or remote location.
- Catalogs efficiently and effectively serve niche avocations and vocations, serving Americans and allowing these businesses to be productive at a lower cost of operations. They help "level the playing field" with larger companies that have more extensive sourcing operations.
- Catalogs provide an important distribution option for small- and medium-sized manufacturers, importers, wholesalers, inventors and designers, all of whom do not have the scale, sophistication or capital to sell their products to the "Big Box" retail giants, which demand prices that are impossible to meet.

- Catalogs provide a national market test for new products and the discovery of small niche market opportunities that would otherwise require large budgets and sophisticated deployment. This creates greater innovation and broader consumer solutions than would be possible otherwise. For example, the electronic thermometer, which is now a standard for families with newborns, was developed in exactly this manner.
- Catalogs provide a national audience for small companies and start-up operations, helping keep small business as the largest creator of jobs in our economy.

Catalogs are Good for Disadvantaged and Rural Americans

- Catalogs can be the only alternative for shut-ins, infrimed, handicapped, elderly or those with limited mobility.
- Catalogs provide viable shopping venues for rural citizens who live too far from stores.
- Catalogs provide the older population with well-being benefits. The regular contact with letter carriers and delivery service providers who deliver packages to the home reduce the sense of isolation and provide beneficial human contact and a "safety-net," helping seniors stay connected to the community and creating a sense of normalcy so critical to well-being and mental health.
- Catalogs enable people to lend a helping hand to those they do not know, including the poor, destitute or imperiled throughout the world (consider, for example, Heifer International, CARE, NWF or other nonprofits that have catalog businesses).
- Catalog companies do not have to be located in urban centers and can instead create quality jobs for rural America. High-employment catalog companies are found in locations such as Freeport, Maine; Dodgeville, Wisconsin; Dyersville, Iowa; and many other remote locations.

Catalogs, Their History, and Their Role in American Commerce

- Interstate commerce developed because of catalogs.
- Rural free delivery was spurred on by catalogs.
- Parcel Post developed the required scale due to catalog shipments.
- Early catalog brands were among the first to have a national identity.
- More than half of America shops via catalogs.
- Catalogs allow marketers to have a national footprint without being a mass merchant, having helped develop the idea that we can have national brands without the requirement to open stores in every state.
- Baby Boomers buy more from catalogs — per capita — than any other generation.
- Catalog use increases with the age of the consumer, particularly pertinent in "the graying of America."
- Catalogs provide important content to keep mail relevant and welcome in the household.
- Cataloging did $270 billion in sales in 2006 and supported more than 20,000 different firms, as well as thousands of supplier companies and service vendors.
- Cataloging economics fundamentally changed in 2007 and have spurred industrywide experimentation to reduce mail volumes, down 35% two short years later. That's a figure that will likely continue to grow once catalogers perfect non-mail marketing techniques.

Catalogs and the Internet

- As a whole, catalogers were pioneers in the use of the Internet for the sale of products and services to consumers and businesses.
- By in large, catalogers receive about half their orders online depending on the product category and demographic they serve—yet the paper catalog is responsible for

generating more than half a company's online sales (some companies report it is upwards of 90%). The symbiotic relationship between the paper catalog and online technology yields greater convenience for everyone from single, working moms to full families, to the elderly, to the physically handicapped, further driving social and environmental benefits, time and efficiency.

- Catalogs are also drivers of retail traffic, promoting commerce, jobs, and convenience for brick and mortar retailers.
- With rare exception, every cataloger has sophisticated e-commerce deployment, making full use of all established and most emerging, technologies.
- Catalogers largely do not distinguish between mail and Internet as business objectives. They see it as being about communicating with people in the way they want to be reached via media consumers already use. It is also about using the most efficient and desirable means possible to stay in touch with customers. The combination of the catalog plus the Internet creates a very powerful marketing and distribution system that impacts and improves lives.
- Catalogs establish brands then extend those brands' reach to the Internet, offering Americans hard-to-find products at value-based pricing.
- Catalogs help consumers feel confident about online purchases. Catalog merchants have a long and protected tradition of honoring their commitments as responsible, customer-oriented, integrity-driven businesses.
- Catalogs prompt people to tell others through social media (i.e., blogs, Twitter and Facebook) about the products that inspire. This "viral" effect of community and commerce has multiplicative financial and emotional benefits. It also increases consumer satisfaction and marketer responsiveness by providing a ready forum for customer comments, reviews and feedback.
- Catalogs provide an alternative transactional method for those Americans concerned about online privacy or transactional safety.
- Catalogs still have the highest order response of any vehicle available to direct marketing. Consumers "vote with their feet." This indicates that a great deal of value is put on the receipt of a catalog that creates a residual benefit for both online commerce and the American economy.

Conclusion

Since the mid-1990s, many experts have predicted the extinction of the printed catalog. However, until the double-whammy of the huge postage increase of 2007 and the Great Recession of 2008-2009, catalogs in America continued to thrive, aided and enhanced by the maturation of Internet marketing. As both the general economy and postal rates settle down, it will be proven that "rumors of catalogs' demise" continue to be over-stated.

With catalogers' continuously responsive use of recycled paper and tree replanting, as well as their close attention to self-regulation, this responsible industry is primed for greater growth going forward.

Last revised: May 16, 2010

Dr. Michael J. Riley
431 Pinewood Lake Drive, Venice, FL 34285
Tel: (941) 244-0416 home (703) 338-9635 cell Michael@Riley.net

May 31, 2010

Representative Stephen F. Lynch
Chairman
Subcommittee on Federal Workforce, Postal Service
And the District of Columbia
2157 Rayburn House Office Building
Washington, DC 20515

Dear Representative Lynch,

Thank you for allowing me to testify before your committee. Below are my answers to your questions:

Question 1:
Are you advocating that workshare discounts should be set so that they are less than the costs avoided so the Postal Service shares in the benefits of worksharing?

Answer: YES! I also wish to add that when, as now, discounts are set too high the Postal Service suffers not only by losing revenue but also due to the fact that its operations are made less efficient. Worksharing began as a transition to automation. Automation has been installed at great expense. By siphoning off volume, excessive discounts not only make the entire postal industry less efficient, they have a direct adverse effect on the efficiency and return on investment (ROI) of postal automation.

Question 2 :
With the assistance of Dr. John Panzar, the Postal Service's Office of Inspector General recently released a report which found that the current law provides the Postal Service with a strong economic incentive to set workshare discounts below avoided costs. Do you believe that the Office of Inspector General and Dr. Panzar are correct in their assessment?

Answer:
I have not read the study by John Panzer and the IG, nor am I a lawyer, but I believe that the Postal Service acts as if it had a strong incentive to set discounts above avoided costs, not below them. If the OIG and Dr. Panzer have concluded that the natural economic incentive is to set discounts below costs avoided, that would seem to confirm my judgment that it should be done. The goal should be to preserve the Postal Service and preserve postal services.

Question from Rep. Kucinich:
Your testimony echoes my concern that much of the Postal Service's proposals for a healthy USPS focus on cost reduction through cuts in essential services, rather than addressing current policies that result in the loss of desperately needed revenue. PRC

Dr. Michael J. Riley
431 Pinewood Lake Drive, Venice, FL 34285
Tel: (941) 244-0416 home (703) 338-9635 cell Michael@Riley.net

Chairwoman Ruth Goldway and national postal worker unions have also expressed this concern. They have provided excellent ideas for revenue generation that warrant

further examination. Examples of these proposals include providing government services at local post offices, providing retailers a space to sell their service or products, implementing a vote-by-mail system, and having a range of products that are trackable and traceable to compare with private companies that provide that service. You provide some of your own ideas to increase mail volume, and as a result, revenue. Your proposals pertain specifically to mail products, while previous discussions in this Subcommittee pertain to revenue-generation ideas outside of the USPS' historical mission. Have you considered the viability of the revenue-generation methods that have been proposed, including the ones I just mentioned? Which proposals do you believe have the most promise, and why?

Answer:
I have considered many proposals to increase revenue and believe that those with the most promise of new profitable revenue should be considered and tried. At present, the Postal Service lacks the availability of money to spend on these ideas. New ideas for service are closer to the postal mission and fit better with existing systems than selling products. In the 1990s, the Postal Service experimented with selling products and it lacked the infrastructure of a retail operation that was necessary to make this a success. Many Post Offices lack the space for such operations.

Nevertheless, it is possible for a healthy Postal Service to build or buy facilities much like the strategic acquisitions of Kinkos by Fed Ex and of Mail Boxes, Etc. by United Parcel Service. My opinion is that there are significant opportunities to quickly grow profitable revenue in parcel delivery such as the Priority Mail, "If it fits it ships" advertising. Providing an enhanced service for "Snowbirds" and for all Americans who travel and want their mail seems to me to be the idea with the best immediate potential.

I learned long ago, that no one of us is as smart as all of us. I have great respect for postal employees and the members of the PRC. Many have offered suggestions with high potential that fit with existing systems. If the postal Service can maintain long term profitability and use the funds for investment, then far more opportunities become possible. Each idea must be fully integrated into marketing, operations, finance and customer perception. These ideas must also be politically acceptable.

Sincerely,

Michael J. Riley

June 4, 2010

The Hon. Stephen F. Lynch
Chairman
Subcommittee on Federal Workforce, Postal Service,
and the District of Columbia
Committee on Oversight and Government Reform
House of Representatives
2157 Rayburn House Office Building
Washington DC 20515-6143

Dear Chairman Lynch:

The following are my answers to the questions set forth in your May 20 letter as a follow up to my testimony before the Subcommittee on May 12. Please do not hesitate to contact me if you have any further questions.

QUESTION 1:

"Your testimony states that you believe that periodicals likely covered their short-run attributable costs. Should the Postal Service and the Postal Regulatory Commission be looking only at short-run attributable costs for periodicals? Should costs be looked at more frequently than on an annual basis, such as quarterly or seasonably?"

ANSWER TO QUESTION 1:

I am not an economist, but I believe that when there is excess capacity that causes short-run attributable cost to be less than long-run variable costs, then short-run attributable cost is the correct metric. As you know, the Postal Accountability and Enhancement Act does not provide a definition of attributable costs for market dominant products, but the attributable cost factor in the PAEA requires consideration of the "direct and indirect postal costs attributable to each class or type of mail service through reliably identified causal relationships." As I explained in my testimony, Periodicals have not caused the Postal Service's excess capacity and resultant manual handling, and these costs should not be attributed to Periodicals.

Pricing Periodicals in accordance with the class's short-run variable costs is consistent with established economic principles. The distinguished economist Alfred E. Kahn has written that price should be equated to short-run marginal cost because that correctly reflects the social

opportunity cost of providing the additional unit that buyers are at any given time trying to decide whether to buy.

I think that the Postal Service should look at its costs as frequently as they can be practically and reliably measured. This will help them identify opportunities for improving efficiency and reducing costs. In fact, I have often criticized the lack of cost data by class of mail in individual postal facilities. This impedes recognition of elevated costs in specific operations such as the bullpen I described in my testimony. In terms of Postal Regulatory Commission review of attributable costs, practical constraints make an annual review of attributable costs reasonable.

QUESTION 2:

"Your testimony states that periodicals costs are overstated because periodicals are incorrectly charged for unnecessary mail processing. Are you saying that you believe that the costs are inaccurate, or are you saying that the Postal Service should be utilizing its labor differently?"

ANSWER TO QUESTION 2:

Both.

First, the Postal Service handles an excessive volume of Periodicals manually, a practice that publishers have not requested and do not benefit from. The Postal Service's own costing system (IOCS) shows that USPS personnel are spending more time manually sorting Periodicals mail than sorting it on machines, in spite of years of investment in flats automation that was supposedly going to reduce Periodicals costs sharply. With more machine capacity and declining volume, one would expect more mail to be processed on the automation equipment. Instead, the opposite has happened. In FY 2008 and 2009, the Postal Service spent almost twice as much on manually sorting Periodicals flats as on machine sorting them. As flat mail volume dramatically declined in FY 2008 and again in FY 2009, the Postal Service used about the same number of man-hours to process Periodicals flats in each year. This resulted in a unit cost increase of more than 28% and a decline in productivity of approximately 17%. Clearly, the cause was not Periodicals but the Postal Service's inability to adjust its workforce and to take full advantage of its automation capabilities. As I said in my oral testimony, "Something is clearly wrong with this picture." I believe that the solution is for the Postal Service to reduce its mail processing labor force to more closely align with the volume of flat mail. Employees should not be assigned to Periodicals manual processing areas simply to keep busy.

Second, the Postal Regulatory Commission's costing methodology inappropriately attributes these excessive manual handling costs to Periodicals. As I mentioned in my testimony, the Commission assumes that mail processing costs are 100% volume variable, meaning that if volume drops or if a more efficient mail-processing technology is introduced, mail-processing costs will immediately decrease accordingly. This does not in fact happen: the postal labor force, especially full-time workers, is never instantly reduced to reflect declining volumes or improved technology. As I stated in my written testimony, a number of respected economists have studied this issue, and nearly all have concluded that mail processing volume variability is only in the range of 70 - 85%. As mentioned in my response to question 1, the PAEA requires that

attributable costs be determined "through reliably identified causal relationships." These manual handling costs are caused by the failure to eliminate unneeded labor capacity as automated technologies are implemented or as volumes experience sustained declines, not by Periodicals Mail. These excess labor costs should be assigned as institutional costs – not Periodicals costs.

QUESTION 3:

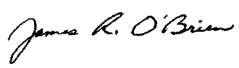
"If a mailer identifies or has concerns with the reliability of cost estimates used by the Postal Service or Postal Regulatory Commission to allocate costs between products or classes, is there a method for the mailer to have those concern[s] addressed and remedied by the Postal Regulatory Commission? To your knowledge, has any periodicals mailer brought any such concerns to the Postal Regulatory Commission for consideration since the passage of the Postal Accountability and Enhancement Act?"

ANSWER TO QUESTION 3:

In providing for much-needed streamlining of the ratemaking process, the Postal Accountability and Enhancement Act necessarily reduced somewhat the opportunities for mailers to challenge the Postal Service's or the Commission's costing methodologies. Under the Postal Reorganization Act of 1970, the Postal Service was required to subject its cost estimates to the rigors of a full-blown litigation, in which mailers had an opportunity to conduct written discovery and cross-examination of the Postal Service's witnesses and present independent testimony contesting the Postal Service's conclusions. Under the PAEA, mailers can express concerns about the reliability of cost estimates by raising them directly with the USPS; or by submitting comments in various Commission proceedings such as the Annual Compliance Review. And the PAEA's complaint process is available if a mailer believes that erroneous cost estimates have resulted in rates that are in violation of the law.

Both the Commission and the Postal Service have attempted to be responsive to the need for an effective mechanism by which mailers can question or challenge Postal Service cost estimates under the new law. The Commission has adopted regulations governing "Procedures for Changing Analytical Principles" that require the Postal Service to petition for an informal Commission rulemaking proceeding whenever it desires to change any of the analytical principles underlying its costing analysis and that permit any interested party to petition for such a rulemaking if it believes a change to analytical principles is desirable. MPA and Time Warner have both been active in commenting on USPS proposals and in recommending analytical changes that the Postal Service has subsequently brought the Commission for approval.

Sincerely,



James R. O'Brien

QUESTIONS FOR THE RECORD

Responses submitted by Dr. John Waller, Director, Office of Accountability and Compliance
Postal Regulatory Commission
to the

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE,
AND THE DISTRICT OF COLUMBIA
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

Hearing on, "The Price is Right, or is it? An Examination of USPS Workshare Discounts and Products that do not Cover their Costs"

May 12, 2010

Questions From Chairman Lynch:

1. ***Please provide an estimate of the amount of revenue forgone as a result of the discounts provided to nonprofits.***

The amount of revenue forgone as a result of special reduced price requirements contained in Title 39 of the U.S. Code are estimated by the Commission for each fiscal year based on data provided by the Postal Service. The estimates are included in the Commission's Annual report. The latest published numbers for forgone revenue are $1.104 billion for FY 2008 and $0.982 billion for FY 2007. The bulk of the forgone revenue is in the Standard Mail class, as shown on page 31 of the Postal Regulatory Commission Annual Report to the President and Congress for FY 2009. The full annual report is available on the Commission's website at www.PRC.gov.

2. ***If a mailer identifies or has concerns with the reliability of cost estimates used by the Postal Service or Postal Regulatory Commission to allocate costs between products or classes, is there a procedure for the mailer to have those concerns addressed? If so, please describe such procedure and the number of times that the procedure has been used since the passage of the Postal Accountability and Enhancement Act.***

Prior to the passage of the Postal Accountability and Enhancement Act of 2006 (PAEA), omnibus rate cases included a presentation by the Postal Service of its preferred costing methodologies. Often, intervening parties would criticize the Postal Service proposals and/or the existing estimation techniques and propose modification of various aspects of the cost attribution and other costing methods. These dockets typically lasted for ten months during which the cost estimation proposals

could be carefully analyzed. Under PAEA, rate cases are concluded in less than 45 days instead of the 10-month duration of PRA rate cases. As a practical matter, this precludes a thorough review of costing methods during rate casts. As a result, the Commission will take note of proposals for changes in methodology and then establish a follow-on docket to carefully consider them.

To provide an appropriate venue to consider proposed methodological changes under PAEA, the Commission issued rule 39 C.F.R. § 3050.11 "Proposals to change an accepted analytical principle in the Postal Service's annual periodic reports to the Commission"[1] in Order No. 203 (April 16, 2009). The relevant parts of the rule may be found on pages 61-62 of PRC Docket No. RM2008-4, "Notice of Final Rule Prescribing Form and Content of Periodic Reports".

The rule allows for proceedings to modify costing methodologies "to improve the quality, accuracy, or completeness of the data or analysis of data contained in the Postal Service's annual periodic reports to the Commission" and it allows for any interested person, including the Postal Service or a public representative to petition the Commission to initiate such a proceeding. Since the passage of PAEA, the Postal Service has filed with the Commission 43 proposed changes to costing methods. To date, no such proposals have been filed by mailers or other persons, but mailers have included proposals in comments as part of other dockets.

For example, one method by which mailers can make their concerns known is through the Annual Compliance Determination (ACD) process. Ninety days after the close of each fiscal year, the Postal Service files with the Commission an Annual Compliance Report (ACR) with detailed cost information on the previous year, including cost estimates for each product and mail class, and worksharing avoided costs. The Commission has 90 days to analyze the ACR comments and produce its Annual Compliance Determination.

The Commission establishes a docket for the public to provide commments and reply comments on the cost methods and data filed in the ACR and used to produce the ACD. The cost methods used to develop the estimates are required to be those previously approved by the Commission. On occasion, however, a new method is proposed, as occurred in the 2008 ACR. In that instance, the Commission organized a technical conference to consider the Postal Service's proposed cost change and received input and alternative proposals from mailers. However, the standard procedure is for the Commission to take into consideration what is said about methodologies during the ACD process but generally the Commission can not adequately review or resolve changes of that nature within the 90 day period for Commission analysis. Afterwards, if appropriate, the Commission initiates a "follow- on" docket to formally consider the proposed change in cost methods.

Potential problems with cost estimates and proposed changes may also be brought to the Commission's attention during the review of proposed price modifications. The Commission may then initiate a separate docket to determine whether, and what, changes should be made. This situation occurred during price change considerations by the Commission in 2009. In PRC Docket No. R2009-1,

[1] An "Analytical Principle" is defined as a particular economic, mathematical, or statistical theory, precept, or assumption applied by the Postal Service in producing a periodic report to the Commission. *See* 39 C.F.R. § 3050.1(c)

parties debated the methods for estimating the costs avoided by worksharing. At least two mailers proposed several cost estimation changes. Those proposals have since become the subject of a "follow-on" docket, RM2009-3, Consideration of Workshare Discount Methodologies.

3