

TESTIMONY OF  
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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

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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	-	-	-	-
<b>Total</b>	<b>206,106</b>	<b>149,559</b>	<b>73</b>	<b>14,399</b>	<b>14,065</b>

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.