Testimony of John Waller
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on Behalf of the Postal Regulatory Commission
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Postal Service and the District of Columbia

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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.

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