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.

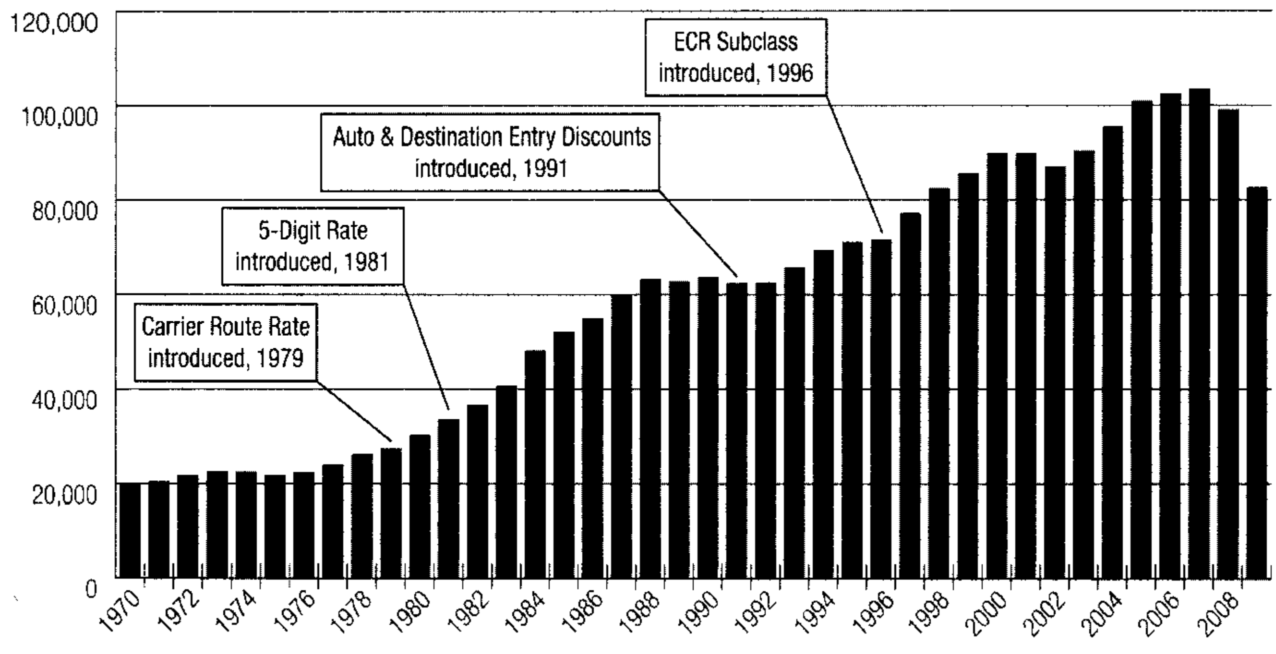
The Postal Service is doing its part operationally as well. Last year, we took over $6 billion in costs out of operations and reduced our career labor force by 40,000 largely through attrition and retirement. We are continuing these efforts and expect to further reduce costs by $3.8 billion this fiscal 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 <u>not</u> 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 **<u>each</u>** 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.

###