REBUTTAL TESTIMONY

OF THE

GREETING CARD ASSOCIATION

March 13, 2003

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Greeting Card Association

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Mr. Dennis Shea
Executive Director
President's Commission on the United States Postal Service
1120 Vermont Avenue, NW, Suite 971
Washington, DC 2005

Dear Mr. Shea:

Enclosed please find rebuttal comments from the Greeting Card Association.

We are pleased to have the opportunity to present our comments in rebuttal to those comments and testimony of others with whom we disagree.

The task of the Commission is a difficult one, and allowing rebuttal comments is an important step in attempting to better understand the complex issues involved.

Sincerely,

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Executive Vice President

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The Greeting Card Association (GCA) herein presents reply comments on some important issues addressed in the initial (February 12) round of public submissions. Consistent with the view expressed in our own Initial Comments, GCA has focused on three especially significant areas: (i) maintenance of adequate, affordable universal service, (ii) the need for change in the present volume-oriented Postal Service business model, and (iii) the necessity for strong, effective regulatory protection of captive customers. We also comment briefly on two other, more specific areas: the question of privatization of the USPS, and proposals for rate flexibility through negotiated service agreements (NSAs).

Universal service issues. Even some commenters that support the concept of universal service along the general lines of that furnished today also express doubt that it can, or should, be maintained at today's levels. Such comments too often assume that universal service is just another cost variable, which can be reduced without both eviscerating the USPS' public service mission and risking adverse effects on its future viability. The Mail Order Association of America (MOAA), for instance, suggests[1] that

> There should be a reexamination, however, of whether that [i.e., the universal service policy] requires delivery to all addresses six days per week. *The Postal Service could save substantial costs through a reduced schedule of delivery for some areas* while still providing the necessary level of service.

The Reader's Digest Association (RDA) and AOL Time Warner make similar suggestions.[2]

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[1] MOAA Comments, p. 4 (italics added)..

[2] Comments Submitted by the Reader's Digest Association, pp. 5-6; Comments of AOL Time Warner, pp. 1-2. AOL Time Warner, perhaps reflecting its status as a major presence in both hard-copy and electronic information markets, adds "proliferating availability to consumers of alternative sources of information and communication, most notably the internet" as a reason why the "current universal delivery system needs a fresh look." Such availability may be proliferating, but is still far from universal; according to the Commerce Department report *A Nation Online: How Americans Are Expanding their Use of the Internet* (Economics and Statistics Administration, February 2002), a little more than half (54 percent) of American households had Internet connections.

Viewing the problem of falling volume and an expanding network as purely a question of cost reduction ignores the value – and hence volume – that could be lost as a result of substantial reductions in the frequency, uniformity, or quality of delivery. Indeed, it is troubling that the comments suggesting reductions in universal delivery service do not attempt to quantify possible cost savings, let alone balance them against possible detriments. The *maximum* possible annual saving from eliminating a day of delivery has been put at $1.9 billion[3] – as compared with an annual budget of well over $70 billion. At the very least, the general magnitude of possible damage from pursuing this (rather modest) cost reduction should be estimated and compared with the possible savings – and the same principle should govern with respect to any other major diminution in service that might be presented as a cost-saving maneuver.

Some commenters recommend that universal service be limited to a level dictated by "customers' needs."[4] The Commission should consider carefully what these commenters mean by "customers": specifically, do they include in that term mail *recipients* – or only the business mailers who pay the postage? Since the Postal Service, traditionally and by its present statutory charter, is a public-service institution, the needs of recipients must be considered along with those of mailers. The assumption that diminution of today's universal service is (no more than) an unproblematic cost reduction measure plainly

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[3] Testimony of Robert H. Cohen, Director of Rates, Analysis and Planning, Postal Rate Commission, at the February 20, 2003, hearing, at p. 2.

[4] The Direct Marketing Association, for instance, argues (Comments, p. 3) that

> Contrary to popular belief, the Postal Service does not now deliver to everyone, everywhere, everyday or even six days a week. The extent to which it does not now do so is based on customers' needs.
>
> The DMA supports the notion of universal service in this context, *i.e.*, meeting the changing needs of customers. Moreover, we believe it could prove counter-productive to lock into any new law a nationwide standard that would burden the system

reflects a failure, or refusal, to consider the interests of households and businesses in their capacity as mail recipients.

Many commenters[5] recognize that the Postal Service, faced with a long-term, exogenous decline in First-Class letter volume, cannot continue to rely on volume growth to finance its growing delivery network. But even some that do recognize this fact go on to present suggestions that would exacerbate the problem. For example, the Direct Marketing Association (DMA) appears to acknowledge the threat to postal volumes, and hence to the viability of the national network – but it also proposes to allow exceptions to the "mailbox rule" so that private parties could place material in customers' mailboxes.[6] The obvious effect of such exceptions would be a form of cream-skimming. Mailers would seek the "most affordable and efficient" delivery by themselves serving routes whose high volume or low cost per stop made it cost-effective to do so, while leaving the less profitable routes to the Postal Service.[7] The Reader's Digest Association, which lucidly summarizes the volume/cost "vicious cycle" at page 2 of its

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either with costs of services that exceed the customers' needs or restrictions preventing the Postal Service from meeting even greater service needs.

[5] Including GCA; see our Initial Comments, pp. 3-5.

[6] See DMA Comments, p. 5:

> We support, in a modified form, the Mailbox Rule (*i.e.*, the letter-box monopoly, which permits only pieces for which postage has been paid may be placed in a letter-box). We believe that the Mailbox Rule strengthens the economies of the delivery function of the Postal Service, also known as "the last mile." *However, we believe the Postal Service's control of the mailbox should not be absolute. Rather, access to the mailbox should be allowed to licensees in order to ensure the most affordable and efficient "last mile" delivery function.* [Italics added.]

Advance Magazine Group (Comments, p. 2) makes a similar proposal.

[7] By withdrawing volume from the Postal Service only where the mailpieces would be delivered on "profitable" routes, the suggested licensing procedure would both lower total USPS revenue and raise the average cost for the mail that remained. The only beneficiaries would be those large mailers that could take advantage of the availability of licenses.

Comments, nevertheless makes a volume-losing recommendation similar to DMA's at pages 4-5.[8] Suggestions of this kind are evidently directed solely at the interests of the large-scale commercial mailers[9] involved, and not at preserving the overall viability of the Postal Service.[10] The way to accomplish that goal, we suggest, is, rather, to keep volume *in* the system by maintaining its universality, securing legitimate cost efficiencies, and insuring that the Postal Service continues to be perceived as the most desirable channel for business-to-customer and customer-to-business communication.

The Postal Service business model. Much of our criticism of these large-mailer-oriented proposals is likewise relevant to the problem of the Postal Service's outmoded business model. The implication of some of the proposals is that making mailing cheaper for large users will cure or at least alleviate the problem. Once again, however, little concrete or quantitative help is provided for the Commission.[11] But this is an area in which some insight into the magnitudes involved is vital.

The volume-decline problem is widely agreed to be caused largely by diversion of transactional letter mail to e-media. Business mail users, insofar as they engage in or promote such diversion, do so in

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[8] RDA argues that "[c]ompetition will lead to efficiencies." Ibid. But if, as would naturally be expected, private licensees opt to deliver only on routes that are already "efficient" (in the sense of low cost per piece delivered), the only result would be to transfer the returns from such efficiency from the Postal Service and its customers generally to the mailer holding the license. For reasons explained in the previous footnote, the "efficiency" of the Postal Service could actually decline.

[9] We distinguish between large *mailers* and large *businesses* since, as Alliance of Independent Store Owners and Professionals/Small Business Legislative Council argues at length (Comments, pp. 2 et seq.), shared-mail advertising handled by a very large mailing enterprise may indeed include many small business ads. Cf. Advo System, Inc., Comments, pp. 1, 4.

[10] It is, on the other hand, encouraging to see that at least one large mailer – AOL Time Warner – has recognized that public funding of non-self-supporting public service functions of the USPS should be considered seriously. AOL Time Warner Comments, pp. 3-4.

great part because of its extraordinary cost-reducing potential.[12] The size of the available cost reductions has, clearly, a direct bearing on the prospects for retaining transactional messages as hard copy by reducing postage rates.

A study done for the Postal Service in 2000[13] estimated that a business using electronic bill presentment and payment (EBPP) in place of postal delivery could save $1.90 per bill. Significantly, only 40 cents of this represented postage avoided. At current rates, the lowest available rate for a one-ounce First-Class letter is 27.5 cents.[14] All else being equal, cutting this rate by *one-third* would merely reduce the savings found by PriceWaterhouse Coopers to about $1.81 per bill. Several years ago, the Office of the Comptroller of the Currency published estimates of per- transaction costs for various bank payment

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[11] AOL Time Warner does provide some suggestive concrete examples, at pp. 3 and 14-16 of its Comments. (We emphasize, however, that we do not agree with the inferences AOL Time Warner urges the Commission to draw from them.)

[12] MOAA (Comments, p. 3) puts the matter well:

> . . . The largest and continuing threat is electronic diversion of mail. Much of First Class Mail consists of statements of account and the payment of those accounts. That portion of the mail will continue to shrink. The electronic rendering and payment of bills represents cost savings to both businesses and the consumer that are so dramatic that continuing diversion is inevitable. . . .

Unfortunately, the conclusion MOAA draws from these facts is a perverse one: that because some hard-copy letter mail appears to be disappearing altogether, the existing USPS letter monopoly does not offer the once-expected revenue protection and should be abolished. This confuses the effects of the letter monopoly *within* the hard-copy delivery market with the effects of a new substitute product *outside* that market. Allowing cream-skimming in the hard-copy area would further raises USPS' unit costs. The same confusion appears in DMA's Comments, at p. 4.

[13] PriceWaterhouse Coopers, *Projecting Electronic Diversion for First-Class Mail in the H.R. 22 Simulation Model* (February 7, 2000), p. 5.

[14] PRC Op. R2001-1, Appendix One, Rate Schedule 221. The 27.5-cent rate is for Automation letters presorted to carrier route – a relatively small-volume category, accounting for about 1.8 percent of all Automation letter volume and about 0.9 percent of all First-Class letter mail (PRC Op. R2001-1, Appendix G, p. 2)

formats[15]: they ranged from 95 cents for an in-person check payment at a teller window and 45 cents for a telephone payment to *one cent* for an Internet payment transaction.[16]

Cost disparities this large suggest that price-cutting would be more likely to dissipate needed revenue[17] than to retain transactional letter volume. The better course, we believe, may be to maintain – and vigorously market – the Postal Service's inherent advantages: universality, privacy, security, and ability to deliver messages in permanent, tangible form without material investment[18] or further effort by the recipient.

Ratemaking and regulatory protections. Commenters' suggestions for change in the regulatory process are numerous, but fall into certain broad categories. Some are directed – or could be directed – toward overall cost control. Others aim simply at revamping ratemaking in the interest of large bulk mailers.

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[15] Karen Furst, William W. Lang, and Daniel E. Nolle, "Technological Innovation in Banking and Payments: Industry Trends and Implications for Banks," *Quarterly Journal*, vol. 17, no. 3 (September 1998), p. 28.

[16] A related, if more subtle, downward pressure on use of the mails for these transactions may come from competition among vendors and financial institutions themselves. For example, a bank which succeeds in converting much of its bank-to-customer transactional volume to e-media gains a cost advantage – and hence a competitive edge – over banks that lag in effecting the conversion. See Furst, et al., *op. cit.*, p. 23.

[17] Perhaps indirectly, by discouraging other mail volume through cuts in service (see National Postal Policy Council Comments, p. 9), reductions in universal availability, or merely loading the unrecovered costs onto "non-transactional" mailers.

[18] Generalized predictions that the Internet will supersede letter mail should be viewed in light of the cost – in time and skill acquisition as well as dollars – required to transact business on-line, as compared with the virtually costless process of "connecting to" the postal system. Dollar cost is evidently an important factor; according to the Commerce Department report cited earlier, Internet usage for households with incomes above $75,000 ran at almost 80 percent; for those below the $15,000 level, at around 25 percent. *A Nation Online*, supra, p. 11, fig. 2-2.

Prominent among the first type of proposal are recommendations of a price cap or similar mechanism in place of the present cost-based ratemaking system.[19] This is, theoretically[20], a possible mechanism for achieving a degree of overall cost control – though, as often presented, at the cost of eliminating the ratemaking oversight needed to protect captive customers.[21] But the same cost control objective could be achieved by providing the independent regulator with adequate authority over the revenue requirement.[22]

A large number of proposals call for reducing or abolishing independent rate regulation – at least for some types of mail. Commonly these schemes involve setting of rates by the Service, with review limited to an after-the-fact complaint.[23] A complaint procedure would shift the burden of assuring fair rates onto parties who may not have the means to do so. Sometimes other deregulated industries are held

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[19] See, e.g., RDA Comments, p. 6 (price increases capped at CPI change less a productivity factor); AOL Time Warner Comments, p. 13 (increases limited to the rate of inflation);

[20] To be effective, a price-cap system needs a "residual claimant" – an interest whose only claim to the revenues of the enterprise is to the "residue" following payment of all expenses, including personnel costs. Normally, in the private sector, this will be the equity interest. Attempts to cast Postal Service managers and employees in the "residual claimant" role, through a bonus program, must face the difficulty that, unlike the common stockholder, they may have a conflicting interest in maintaining some of the same costs the price-cap system seeks to reduce.

[21] AOL Time Warner's proposal, cited in footnote 19, does attempt to combine an overall price cap with at least some measure of rate oversight; and the Association for Postal Commerce (PostCom) would preserve regulation for "the one class or subclass . . . subject to the statutory monopoly" (PostCom Comments, p. 4) – but does not explain how total costs would be recovered without loading any losses from other classes' unregulated rates onto the monopoly customer. Also neglected is the question of whether, and how, caps might have to be periodically revised to maintain USPS' solvency.

[22] Combining such authority with the power to supervise service standards and service performance (which several commenters advocate; see AOL Time Warner Comments, p. 17; RDA Comments, p. 7; and particularly PostCom Comments, pp. 7-8) would guard against one risk in the price-cap model: the incentive to generate surpluses by degrading service quality.

[23] PostCom Comments, p. 4; AOL Time Warner Comments, p. 17; MOAA Comments, pp. 5-7.

up as a model to be followed in the postal system.[24] No information is offered as to how deregulation in these industries has affected the captive customer. In fact, consumers usually fare poorly under deregulation.[25] The Commission should examine this experience before giving favorable consideration to large-scale relaxation of *ex ante* ratemaking controls.

Finally, several commenters argue that mail classification and costing and, correspondingly, the design of rates, should be overhauled in the supposed interest of better reflecting cost. These proposals often advocate a form of "optimization of the combined Postal Service[-] private sector infrastructure"[26], the sole objective of which apparently is to provide mailers that do not need to use every USPS-provided function with the lowest possible rate. As expounded by DMA, for instance, this approach would require non-worksharing mail users to shoulder the fixed as well as variable costs of "upstream" facilities not directly used by large mailers capable of performing mail transportation or processing functions themselves.[27] The "lowest combined cost" at which proposals of this kind purport to aim is thus meant

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[24] PostCom Comments, p. 3; MOAA Comments, p. 5.

[25] Sheldon L. Bierman, Paul A. Nelson, and David F. Stover, "Anomalies in Residential Electric Rates: Harbinger of Competition?", *Public Utilities Fortnightly*, July 15, 1999, pp. 40-47 (1990s retail deregulation experience in the electric industry).

[26] PostCom Comments, p. 4. PostCom argues that the existing process, which estimates the costs saved by mailer worksharing and subtracts them from the rate via a discount, "tends to understate, if it does not entirely ignore, the enormous investments that mailers and their service providers must make in hardware, software, facilities and transportation systems in order to qualify for the discounts." Ibid. Subtracting more than the attributable cost saving necessarily results in reducing the institutional-cost contribution of the discounted mail, and this reduction must be made up elsewhere – i.e., by other mailers, who then, on PostCom's argument, would apparently be made responsible for recovering worksharing mailers' investment. But the mailers and service providers to whom PostCom refers operate in a competitive marketplace, and presumably make their investments on the basis of expected return from their own operations under existing and foreseeable ratemaking regimes. R.R. Donnelley, Comments, p. 13, makes a similar argument.

[27] DMA Comments, pp. 6-7. On DMA's theory, "upstream" functions are, or should be, "open to free competition" (i.e., mailer worksharing). But when a firm holds a monopoly of one subservice – in the USPS' case, delivery – but not others, the "price" for a unit of non-monopoly work should be the

only for the substantial bulk mailer. If the Postal Service is to fulfill its designed public service mission, which entails adequately serving all types of mail users, at fair rates, it cannot adopt this ratemaking philosophy.

Negotiated service agreements. Perhaps the ultimate in such large-mailer orientation can be found in the negotiated service agreement (NSA) mechanism, wherein the Service and a single mailer agree on a unique, non-tariffed rate, perhaps involving special worksharing, a prospect of an absolute increase in mailed volume, or both. Several commenters call for expansion of this concept (AOL Time Warner Comments, p. 12; RDA Comments, p. 7; DMA Comments, p. 8). This is, clearly, a device that only large-scale mailers can use, because of the transaction costs involved as well as because small mailers can offer little in the way of additional worksharing or incremental volumes. In any case, it is probably premature to call for expansion of this barely-launched mechanism, since it was little more than a year ago that the PRC concluded that NSAs could be permissible under the statute, and the first NSA proceeding is still underway. Nonetheless, we suggest that, if NSAs have a role, it should lie in situations where only one mailer, or at most a very small number, can *in fact* provide the specialized worksharing function in question. Where any substantial number can do so, it is wasteful – in terms of both transaction costs and lost opportunities for cost reduction – to obtain worksharing participation "one customer at a time" through contractual negotiation; the PRC has expeditious, and successful, "niche classification" procedures that can make the innovation widely available in short order.[28] Roughly similar

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firm's average incremental cost of not performing it, so that cost avoided equals revenue forgone. If worksharing customers receive a discount reflecting (unavoided) fixed costs as well, the firm will award more in discounts than it saves in cost, an inefficient practice that harms it and its other customers. AOL Time Warner, Comments, pp. 14-16, makes an argument somewhat similar to DMA's.

[28] Consider, for example, *Experimental Periodicals Co-Palletization Discounts,* PRC Docket No. MC2002-3. This case was filed on September 26, 2002, and decided by the PRC on December 20, 2002. The Governors issued their decision accepting the new classification on January 8, 2003. Grand total: 104 days.

considerations apply to volume-inducing discount rates – with the added consideration that predicting volume behavior *of a single firm* is hard if not impossible using normal econometric techniques.[29]

Privatization. Our reading of the February 12 comments, and our observation of the February 20 hearing, encourage us to believe that outright privatization of the Postal Service has gained little support. When we consider the effect on the citizen mail user of some proposals, discussed above, that have been put forward *within the context of a governmental postal system with at least some public-service obligations*, it is, obviously, difficult for us to see any benefit in full-scale conversion to a private, profit-oriented postal corporation. Indeed, profit orientation – not so much of the institution itself as of the investors who would sooner or later become its owners – may be an insuperable obstacle to privatization. While under present law the Postal Service's ability to deal in financial markets is limited in some undesirable ways[30], the existing governmental ownership arrangement does have the advantage of not leaving the Service's fundamental capital subject to short-term fluctuations and a perhaps unduly short-term outlook on the part of those who would be providing under full-scale privatization. We respectfully suggest that such privatization is not a promising candidate for consideration by this Commission.

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[29] Volume-inducing discounts, considered apart from any possible added worksharing element, are also problematic in that (i) if extended broadly they can be self-defeating, since the more users receive the discount, the greater the risk that the expected incremental volume and associated net revenue will not materialize; but (ii) if granted to only a few mailers they raise serious questions of fairness – both because similarly-situated mailers are treated differently and because where mailing is an input to some private-sector business activity the discount customers gain an undue advantage over their competitors. Where the industry affected is one with the potential to convert its hard-copy mailings to e-media, competitors of the favored mailer might well react by accelerating their conversion efforts.

[30] See GCA Initial Comments, p. 14, for an example.