

**BEFORE THE
PRESIDENT'S COMMISSION
ON THE UNITED STATES POSTAL SERVICE**

TESTIMONY OF KATHRYN KOBE

(February 12, 2003)

Kathryn Kobe
Chief Economist
Joel Popkin and Company
1155 15th Street, N.W., Suite 614
Washington, D.C. 20005
(202) 872-0990

EXECUTIVE SUMMARY

Postal Service Partnerships

Although worksharing can benefit both the postal customer and the Postal Service, the wrong incentives sap postal revenues, reduce institutional cost coverage, undermine the Postal Service's efforts to fully utilize its capital and achieve a planned rate-of-return on its investments, and encourage inefficient entry into mail processing. The Postal Service must focus on keeping its own business viable in order to fulfill its universal service mandate.

From the beginning of first-class discounts, it was clearly understood by both the Postal Service and the Postal Rate Commission that the contribution toward institutional costs must be maintained, regardless of whether a piece of mail received a workshare discount or not. When worksharing discounts were first proposed in 1973, mechanization of mail processing was well underway, but even then only 44 percent of letters were receiving their first sort on mechanized equipment. That left a large percentage of mail processing to be done manually. Worksharing, therefore, was seen as a method of bridging from a system of manual processing through mechanized mail processing, to a system of automated mail processing, which was already in the planning stages by the mid-1970s.

Once presort discounts were established, they proved to be difficult to remove or reduce, even after their value to the Postal Service diminished. In 1990, the cost avoided by nonautomated presort mail was calculated as 1.6 cents per piece, but the proposed discount was 4 cents per piece. Current worksharing discounts for First Class mail exceed the Postal Service calculations of avoided costs. The bulk of prebarcoded mail receives either a 7.8 cent or a 9.2 cent discount per piece. Based on Postal Service calculations, cost avoided for First Class prebarcoded mail in three-digit and five-digit categories total 6.3 cents and 7.4 cents respectively, approximately 1.5 cents less than the current discounts that mailers receive for this level of sortation and automation.

Testimony by a Postal Service witness in a recent rate case also showed that Standard (A) mail receives discounts exceeding Postal Service calculated costs avoided. Discounts that are excessive shift the burden of institutional cost coverage onto individuals and small-business mailers who cannot qualify for worksharing discounts. This is not a desirable outcome.

Another problem was created when the Postal Service underestimated the degree of mail shift to first-class automated presort mail in the automation plan for the period 1996 to 1998. Substantially more volume has shifted to the discount category of mail, thus reducing total revenue from first-class mail below anticipated revenue for the volume received.

A different form of partnership is the negotiated service agreement (NSA). Such agreements could provide new volume that would not have been mailed without the optional rates provided. The increased coverage of institutional costs should therefore benefit all users. Provided that negotiated service agreements are structured to achieve such goals, they could provide a useful addition to the Postal Service's ability to serve its customers.

Some other forms of partnerships, through contracting with third parties to perform work that the Postal Service would otherwise perform, have not proven to be successful. Examples include a very costly failure to perform priority mail processing through a private contractor's network, and a centrally managed system of 22 contractor-operated equipment service centers that has proven costly when compared to its predicted cost, and has generated numerous reports from the Postal Service's Inspector General's Office due to complaints about poor performance. This points to the importance of fair and careful analysis and good decision making prior to committing to such partnerships.

Technology Changes

With the current state of technology, it appears that technological change will have an impact on mail due to the increased use of electronic alternatives. However,

one must be careful not to equate every electronic message or transaction with a piece of mail diverted from the postal system. The tremendous growth in e-mail does not reflect a letter lost for each message sent. E-mail has more often replaced telephone calls than letters. The majority of people still see mail as the most reliable and dependable way of receiving and handling their bills, despite several years now in which electronic bill payment and presentment have been available.

Mail volume has recently been severely hurt by four blows within months of each other in 2001: the recession beginning at least as early as March 2001; two postal rate increases in 2001; terrorist attacks in September 2001; and the anthrax attack through the mails in October 2001. The combined effects of these circumstances, each of which would tend to depress mail volume, make it impossible to determine the degree to which conversion to electronic transmissions may be a factor in mail volume declines.

Adding to the difficulty for anyone seeking to gauge the extent of actual or potential electronic diversion from mail is the lack of consistent and accurate data on the type of transactions that could replace mail. For example, estimates of the degree of ownership of personal computers vary substantially. Likewise, estimates of electronic bill payment and presentment range widely.

Available data do make it clear that there is a wide disparity in the ownership rate of personal computers, and in the use of electronic transmissions of all kinds. These differences may be found between age groups, between households with high or low incomes, and in different geographical areas. For example, the highest Internet usage is in urban areas that do not correspond to central city areas. The lowest usage is in urban central city areas. Rural America falls between two urban groups.

To a large extent, the Postal Service has used technology to reduce costs. In 1971, only 25 percent of mail was first processed by mechanized means; all the remainder of mail was manually sorted. To process 87 billion pieces of mail required 277,000 clerks and 45,000 mailhandlers. Today, over 200 billion pieces of mail go through the postal network every year, but require only 257,000 clerks and 59,000 mailhandlers, which is about 2 percent below 1971 employment levels, despite a more

than doubling of the number of pieces of mail moving through the network. Notably, despite the fact that automation directly targeted their jobs, the American Postal Workers Union has never stood in the way of automation, although it has worked for a fair and equitable treatment of employees affected by technological change.

Recently, the Postal Service reported that between 1993 and 2001, letter mail productivity increased 83 percent and that, in the last two years, flat sorting productivity has increased 78 percent.

Investment in automation has been vital to the productivity growth of the U.S. Postal Service, and has allowed it to continue to expand its delivery points without increasing prices faster than inflation. It is critically important that the Postal Service not short-circuit its ability to improve productivity through investment.

Introduction

As the Postal Service moves into this new millennium, it is reassessing how best to accomplish its mandate for universal service against the backdrop of rapidly changing technologies. This paper provides some background on two separate topics that the Presidential Commission has been asked to address: the Postal Services' partnerships with the private sector and how technology both potentially threatens the viability of the Postal Services' business model but also has allowed it to finance an ever growing delivery network without increasing its prices faster than inflation.

Postal Service Partnerships

The Postal Services' partnerships with the private sector take several forms. Some are very obvious, like a FedEx collection box in many post office lobbies. Others are less obvious, such as mail flying in the hold of a passenger plane. Probably the program with the widest array of partners is worksharing, discounts off of regular postage rates if mailers presort and prebarcode their mail prior to entering it into the Postal Service's network. ¹

Under the right circumstances, worksharing can benefit both the postal customer and the Postal Service. However with the wrong incentives, worksharing saps Postal revenues, reduces institutional cost coverage, and undermines the Postal Service's efforts to fully utilize its capital. With the Postal Service facing financial pressures, it cannot afford a discount structure that overcompensates mailers for worksharing activities. It must focus on keeping its own business viable in order to fulfill its universal service mandate.

In conceptualizing workshare discounts, two factors should be considered. The first is that the contribution to the institutional costs of the Postal Service obtained from a workshared piece of mail should be the same as it would be if no worksharing were

¹ For advertising and periodical mail worksharing can also refer to discounts provided to mailers who transport mail to a Postal facility closer to its ultimate destination before entering it into the Postal Service's network, this is referred to as a dropship discount. The concept behind worksharing discounts is that mailer's are provided a monetary incentive to provide mail in a manner that makes it less costly for the Postal Service to process and deliver their mail.

involved. ² If the discount is too large and reduces the contribution of the workshared mail pieces to institutional costs, then mailers who cannot avail themselves of the worksharing discounts must pay a larger share of those costs. Discounts that are too large also provide incentives for competitors in mail processing, who are less efficient than the Postal Service, to enter into the market. To insure that the discounts are not reducing the institutional cost coverage of those pieces, the discount cannot be larger than the costs the Postal Service avoids by the mailer presorting or prebarcoding the mail. Thus, as the Postal Service's mail processing becomes more efficient, the costs that are avoided by presorting and prebarcoding are reduced.

Second, when determining what percentage of the costs the Postal Service avoids will be passed through to the mailer in the form of discounts, the Postal Service should also consider what level of mail volume will ensure the most efficient use of its investment in automation or transportation equipment. It does not make good business sense to ignore this factor when making decisions about the size of the discounts offered to mailers. If this factor is ignored, then the Postal Service does not achieve an appropriate rate of return on its investment.

At the time of Postal reorganization in 1971, some mailers were already providing mail that had been presorted and bundled for faster delivery. While third class mailers received some discounts related to those activities, First Class mailers prepared their mail this way without monetary incentives in order to speed processing and delivery of information important to their businesses. Business mailers today are provided a monetary incentive to presort and prebarcode their mail; however, mailers find a positive benefit, aside from that discount, for the same reason that mailers did in the early 1970s.

² "A simple numerical example will show why the current practice of offering cost-based worksharing discounts is appropriate. If two pieces of mail with attributable costs of 10 cents each are charged a rate of 15 cents, both pieces make a unit contribution to institutional costs of 5 cents and have an implicit cost coverage of 150 percent. If one of those pieces is barcoded, thereby allowing the Service to avoid 5 cents of attributable costs, and that piece is given a 5-cent worksharing discount, its new implicit cost coverage is 200 percent. [footnote omitted] In this example, because 100 percent of the cost savings is passed on to the mailer, both pieces will continue to contribute 5 cents toward institutional costs. Presumably the worksharing piece is better off, because its total costs decline (other wise the mailer would not go to the trouble of worksharing) and neither the Postal Service nor other mailers are worse off.[footnote omitted]" *PRC Opinion and Recommended Decision*, MC95-1, at [3070].

Mail that is prepared in a manner that increases the speed with which it can be delivered is more beneficial to the company sending it.

In 2001 50.5 billion pieces of First Class mail, 48.7 percent of the total First Class mail volume for that year, were mailed at a discount. (Chart 1 shows the percentage of First Class letter mail mailed using discounted rates from the inception of First Class discounts in 1976 through the first quarter of FY2003.) In FY2001, those discounts averaged almost 7 cents per discounted piece and totaled \$3.5 billion, or 9.7 percent of First Class revenues. ³ Standard (A) mail, primarily advertising mail, and Periodicals also have discount structures related to worksharing. Virtually all of Standard (A) mail receives a worksharing discount. Presort and automation discounts make up the first part of the discount structure for Standard (A), similar in concept to those in First Class. In FY2001, those discounts were worth almost double the First Class discounts. Unlike the First Class discount structure, there is a second part of the discount structure for Standard (A) and Periodical mail that is based on dropshipping. This discount applies to mail that the mailer has transported closer to its point of delivery before entering it into the Postal Service's network thus reducing the Postal Service's transportation costs. ⁴

History of First-Class Discounts for Worksharing

Discounts for presortation first became part of the First Class rate structure in 1976 as part of a Stipulation and Agreement between the Postal Service and its users to settle the MC73-1 classification case. From the beginning it was clearly understood by both the Postal Service and the Postal Rate Commission (PRC) that the contribution toward institutional costs must be maintained regardless of whether a piece of mail receives a workshare discount or not. The PRC's Opinion and Recommended Decision

³ FY2002 Billing Determinants are not yet available; therefore, the value of discounts can not be determined yet for a year later than FY2001. FY2001 Billing Determinants, U.S. Postal Service.

⁴ Worksharing discounts are part of the structure for both Regular and Nonprofit Standard A mail. Nonprofit Standard A mail is cheaper than Regular Standard A mail; however, that differential is one that is a public policy choice and is not based on any concept of work shared between the mailer and the Postal Service.

made that point quite clear. "Although the Service admits to lack of experience with presorting, their best information suggests that the one-cent discount will, on the average, be the equivalent of the clearly capturable cost avoidance. Thus contributions to institutional costs will be maintained."⁵

The first discount was set at 1 cent per piece for presortation to 5-digit ZIP and 3-digit ZIP. ⁶ Chart 2 shows several of the most used discounts from their beginning until the present. Discounts have increased from 1 cent to about 7 cents on average. This has dampened the rate of increase in business mailers' postage when compared to postage rates single-piece mailers have experienced. That difference can be seen in Chart 3. If the postage rates of a large business mailer and a single piece mailer were compared for the period from December 1975, when they both would have paid 13 cents to mail a letter to the present, the large business mailer (taking advantage of 5-digit automation discounts) would have only seen his postage rates increase by 113.8 percent whereas a single piece mailer's postage rates would have risen by 184.6 percent.

At the time worksharing discounts were proposed in 1973, mechanization of mail processing was well underway, but even in FY73 only 44 percent of letters were receiving their first sort on mechanized equipment. That left a large percentage of mail processing to be done manually. ⁷ Thus, some presortation of the mail by the mailer saved manual presortation by the Postal Service. With the ZIP code system in place, many mailers could sort their mailing lists to generate the mail in the correct order, thus saving anyone from having to manually sort it. Worksharing, therefore, was seen as a method of bridging from a system of manual processing through mechanized mail processing, to a system of automated mail processing, which was already in the

⁵ Opinion and Recommended Decision, MC73-1, pp 16-17 (footnote omitted).

⁶ 5-digit groupings had to be 10 or more pieces and 3-digit groupings had to be 50 or more pieces. "Postal Bulletin" June 3, 1976, p1.

⁷ Annual Report of the Postmaster General, 1973-1974.

planning stages by the mid-1970s. In its 1980 Annual Report, the Postal Service stated, "[w]e have depended on presort programs to bridge the gap between the mechanization we now have and the automation we plan."

While automation planning and testing was underway by the early 1980s, the postal rate structure was not changed to reflect the primacy of automation until July 1996. That was when the rates determined during the 1995 Mail Classification proceeding were put into effect. Prior to that time the Postal Services' rate cases tended to focus on presort rates first rather than automation rates.

Part of the reason for that long delay in focusing the rate structure on automation is that presort discounts proved to be difficult to remove or reduce, even after their value to the Postal Service diminished. For example the value of nonautomated presort mail, based on cost avoided calculations, declined long before that fact was recognized in the First Class rate structure. In the R90-1 rate case, the cost avoided by nonautomation presort was calculated as 1.6 cents per piece but the proposed discount was 4 cents per piece. The diminished size of cost avoided was attributed by Postal Witness Lyons to improvements in mail processing brought about by improved automation. "[T]he relative value of presort is declining. Simply put, most presort mail now avoids a relatively efficient automated handling as opposed to a more expensive letter sorting machine (LSM) or manual handling."⁸

In March 1995, the Postal Service filed the MC95-1 classification case. This case brought automation to the forefront of the rate structure. The changes to the rate structure in MC95-1 were supposed to be revenue neutral. But assumptions in the Postal Service's automation plan for the 1996-1998 period, which incorporated the expected effects of the reclassification taking place in July 1996, underestimated the shift of mail to First Class automation. The Postal Service expected Postal Service applied barcodes to letter mail to grow from 45.6 billion in FY96 to 62.2 billion in FY98. Instead, Postal applied barcodes totaled 45 billion in FY98 and were down to 43 billion

⁸ Direct Testimony of Ashley Lyons, R90-1, p. 107.

by FY00. Since Postal automation equipment was approved based on the as higher percentage of Postal applied barcodes, there is an implication that current levels do not fully utilize the available capacity. ⁹

As automation has improved mail processing productivity, it has reduced the avoided costs of those activities. However, the Postal Service has difficulty weaning mailers from what the mailers tend to view as an entitlement. In the R97-1 rate case, the Postal Service proposed a further decline in nonautomated presort mail discounts, slight declines ranging from 0.1-0.6 cent in the automated letter discounts, and an elimination of the heavy piece discount. The PRC did "not recommend the Service's proposal to 'shrink' the discounts for non-automated presorted mail, nor does it recommend elimination of the heavyweight discount. In general, the Commission recommends worksharing discounts somewhat larger than the Service proposes." ¹⁰ In the R2000-1 Omnibus rate case, Postal Witness Fronk, testifying on the First Class rate design, stated, "...if the proposed workshare discounts are tied strictly to avoided costs, many discounts would need to be reduced. Instead, the Postal Service's proposal in this docket will generally maintain workshare discounts at their present levels, as discussed in detail below. However, if the cost data presented in this docket are the beginning of a new cost trend indicating that the value of worksharing to the Postal Service has peaked, then the mailing community might anticipate smaller discount proposals in the future."¹¹ Despite the proposal of the Postal Service to maintain the levels of the workshare discounts at current levels, the recommendations of the PRC for R2000-1 increased the discounts slightly for all the automated letter rates and lowered the additional ounce rate by a full cent (the Postal Service Proposal had increased the additional ounce rate by one cent.)

As automation has improved processing productivity, cost avoided calculations can not support ever-increasing discounts. If the discounts do not increase when postage increases, the rate of increase in discounted postage appears to be larger than it is for single piece postage. (Since the discounted rate is lower, an increase of 2 cents will be a larger percentage increase for the discounted rate than the same 2 cents is of the single piece rate.) This larger percentage increase is sometimes interpreted as a sign that the increase in postage rates is unfairly targeted towards mailers using discounted rates. However, rates for workshared mail must meet the test that the

⁹ *Corporate Automation Plan*, May 1996

¹⁰ PRC Opinion and Recommended Decision, MC97-1, at [5028]. This case also marked a change in the Postal Services' methodology for allocating costs. The new methodology, tends to produce lower cost avoided numbers. The PRC is in disagreement with the Postal Service over this change in methodology and continues to allocate costs using their own methodology. This results in two different estimates of costs avoided being presented in the most recent rate cases.

¹¹ Testimony USPS-T-33, page 20 at 15-21.

discount not exceed the costs avoided in order to fairly maintain the cost coverage of the mail receiving discounts. Consequently, the rate of change in the discounted mail rates can not be a determinant of "fairness". In reality, looking again at Chart 3, the mailers using the dicounted rates have not faced large postage increases.

The most recent Omnibus Rate Case, R2001-1 added a new discount for First Class workshare mailers. That is a discount on the additional ounce rate. Previously, single piece mail and workshared mail have paid the same rate on the additional weight for First Class mail beyond the first ounce. However, beginning with R2001-1, the workshared mailers additional ounce rate has been made one half cent less than that paid my single piece mailers. Because the R2001-1 case was decided via a Stipulation and Agreement, this issue was not fully analyzed in the rate making process. In its *Opinion and Recommended Decision Approving Stipulation and Agreement for R2001-1*, the PRC states "[t]he justification for a 0.5-cent rate difference based on additional ounce costs has not been thoroughly explored on the record. Absent the unusual circumstances of this case, the Commission would carefully examine that difference before recommending separate rates for additional ounce single-piece and additional ounce presort mail. However, the rates as proposed have not been shown to be inconsistent with the Act, and as part of the total settlement of all issues, they are acceptable." ¹² Unfortunately, once discounts are in place they are difficult to reduce or discontinue, even if further evidence should prove this proposal is not adequately supported by cost evidence.

Discounts That Exceed Costs Avoided

At first the maintenance of institutional cost coverage sounds complex since the amount contributed toward institutional costs varies for each individual piece depending on the cost of delivering that piece. However, if discounts do not exceed the cost avoided by the Postal Service then identical pieces of mail will contribute equally to institutional costs, whether receiving a workshare discount or not. If discounts exceed

¹² Opinion and Recommended Decision Approving Stipulation and Agreement, R2001-1, [3085]

the cost avoided by the Postal Service then the discounted piece of mail will contribute less to institutional costs than it would if it was sent under the single piece rates. The idea that identical pieces of mail should contribute the same amount to institutional costs is the reasoning used to specify the benchmark piece of mail that is used as the basis for determining cost avoided by the Postal Service. The benchmark piece of mail in the three latest rate cases has been bulk metered mail letters. Those are machinable, typed business mail envelopes that have been metered, and placed into trays all facing the same direction prior to entry into the Postal Service network. Thus, they are most like the letters that are receiving a discount for being presorted or prebarcoded. Another way of thinking of the benchmark mail piece is it is the type of mail that the discounted mail would become if it were to revert back to a single piece rate.

Current worksharing discounts for First Class mail exceed the amount the Postal Service calculates as avoided costs. The bulk of prebarcoded mail receives either a 7.8 cent or a 9.2 cent discount per piece. ¹³ Based on Postal Service calculations, costs avoided for First Class prebarcoded mail in the 3-digit and 5-digit categories total 6.3 and 7.4 cents respectively, approximately 1.5 cents less than the current discounts that mailers receive for this level of sortation and automation. ¹⁴ By definition the benchmark piece of mail used in the calculation of the costs avoided is clean business mail with metered postage that is 100 percent machinable and is entered into the Postal network faced and in trays. As soon as this mail enters the Postal network it is barcoded so that it can be sorted using automated machinery. Consequently, based on mail flow models, this mail compared to 3-digit and 5-digit automated mail requires a barcode be printed on the letter and one or two additional sorts done by automated machines (operating at capacities of 29,000 letters per hour for multi-line optical character readers and 37,000 letters per hour for delivery barcode sorters.) It appears unreasonable to find that

¹³ The majority of letters receiving worksharing discounts are in the 3-digit or 5-digit automation categories.

¹⁴ From Worksheets of Postal Witness Michael Miller, R2001-1.

workshared mail can be saving the Postal Service 8 or 9 cents per piece in avoided costs. 15

Standard(A) and Periodical workshare discounts have not been examined to the same extent as the First Class discounts have been studied. However, in the most recent rate case the following statement was made by Postal Service Witness Moeller about Standard (A) automation rates:

Witness Miller provides estimates of cost avoidance due to mailer preparation of automation letters. While 100 percent is the passthrough underlying the current discounts, it may be necessary to deviate from it in order to avoid substantial reduction in the discounts, or to meet particular rate relationship objectives. Since discounts encourage mailers to make investments in order to qualify for them, extensive reductions in these incentives should be carefully evaluated. The letter automation discounts became smaller as a result of Docket No. R97-1, and would be further reduced if a simple 100 percent passthrough were applied to the newly measured cost figures. For the Basic tier, a passthrough of 110 percent is selected to maintain 80 percent of the existing discount. At the 3-digit tier, a passthrough of 106 percent is selected. This leads to a discount that is a modest 1/10th of a cent greater than the calculated savings but helps achieve the desired 5-digit automation rate relationship...The passthrough at the 5-digit automation tier is 160 percent. This passthrough is principally based on achieving the desired rate relationship with ECR [Enhanced Carrier Route] Basic letters. 16

When discounts are set higher than costs avoided, as indicated by passthrough rates in excess of 100%, then the piece of mail receiving the discount is not contributing the same amount to the incremental costs of the Postal Service as it would if it were not receiving the discount. Since that results in shifting the burden of the institutional cost

¹⁵ In its calculation of costs avoided the Postal Service's cost allocation system indicates that its benchmark letter costs almost 3 cents *per piece in manual* processing costs, about 2 cents per piece more than does the average workshared letter. This is a puzzling finding since the benchmark piece is standard business mail with easily read addresses that are 100% machinable. Yet, that same clean, 100% machinable nonworkshared business mail requires only 1.4 cents less in manual sorting costs than does nonautomation presort mail which is over 50% nonautomatable (which means over 50% of it can not be sent through any of the automated sorting equipment because of its shape or what it has in it.) In fact, Postal Witness Miller makes the statement in his testimony for R2001-1 (T-22 at 6, line 12) "[t]he nonmachinable nonautomation presort mail pieces, however, must be processed manually. Therefore, the mail processing costs for these mail pieces have likely increased over time." The mail flow models of how this mail should be processed through the system do not explain why the actual calculated cost differentials show up this seeming anomaly.

¹⁶ Direct Testimony of Joseph E. Moeller, USPS-T-35, R2001-1, p.11.

coverage onto mailers who can not qualify for worksharing discounts, it is not a desirable outcome.

Negotiated Service Agreements

The Postal Service has indicated that Negotiated Service Agreements (NSA) could play a useful role in better serving its customers and enhancing its revenue stream. An NSA is an agreement between the Postal Service and a specific customer. Currently, the Postal Service has not finalized any NSAs although its first such agreement is currently being analyzed by the Postal Rate Commission.

NSAs could take several forms. They might be used to produce a specialized worksharing agreement between the USPS and a specific customer for worksharing outside the definitions set-up for automation and presort mail. If the discount for such worksharing does not exceed the costs avoided by the Postal Service, it could be a positive solution for the Postal Service and the mailer.

The NSA currently undergoing regulatory review provides for a combination of services to be provided, including free electronic address correction and declining block rates. In theory, declining block rates can be used to promote volume growth by offering a special tariff for volumes in excess of what a mailer is currently mailing. Such special tariffs are somewhat at odds with standard worksharing ideas in that the size of the discounts are not tied to specific cost savings. However, in a situation where mail growth is stagnant, such a system could provide new volume that would not have been mailed without the optional rates and the increased coverage of institutional costs should benefit all the users. Provided NSAs are structured to achieve those goals, they could provide a useful addition to the Postal Service's abilities to better serve its customers. However NSAs that are structured to provide discounts on mail that would have been mailed at the rates already available to all mailers, are not beneficial to the system because they reduce Postal revenues to induce behavior that would have taken place anyway.

Other Postal and Private Sector Partnerships

The Postal Service has participated in several private sector partnerships as part of its various business plans. Some of those have worked better than others. The Postal Service would undoubtedly consider its partnerships with private sector transportation firms to transport mail to be a success for the most part. Contracts with air carriers, for example, keep the Postal Service from having to maintain its own fleet of airplanes, such as Federal Express does.¹⁷ The trucking of mail over long distances is handled by private sector trucking companies.

However, not all of the Postal Service's private sector partnerships are based on sound business decisions. At least one, the Priority Mail centers, has been a notable recent failure. A short discussion of some of the problems related to these partnerships will hopefully provide a basis to learn from past experiences.

Priority Mail Centers

In January 1994 the Postal Service put together a team to determine how to improve the delivery times for Priority Mail. The decision to create a separate network for Priority Mail run by an outside contractor was made in March 1996 and a contract was let in April 1997, three years after the study was begun. Emery, a subsidiary of the CNF transportation company was selected as the contractor to run these centers. A September 1999 Audit Report of the Priority Mail Processing Center Network was produced by the Inspector General's Office of the U.S. Postal Service.¹⁸ That report indicated that the costs of providing the service through the contractor was higher than it

¹⁷ The Postal Service currently has a private sector partnership with Federal Express. Given the restrictions on the type of mail that can be transported by regularly scheduled airlines since the September 11th terrorist attacks, the Postal Service undoubtedly considers this to be a successful partnership because it gives them a means of transporting packages that can no longer be carried aboard regular flights. However, in the absence of those security restrictions, a question might be raised about the higher costs associated with Federal Express' air transportation compared with what the Postal Service had been paying for this type of service from other contractors.

¹⁸ Audit Report-Priority Mail Processing Center Network (DA-AR-99-001), September 24, 1999. While the amount by which the contracted out costs exceeded the estimated in-house costs is redacted in the public version of the September 24th report, a later report (MK-AR-01-003) released September 28, 2001 indicates that mail processed through the contracted network cost 23 percent more than had it been processed in-house without a network.

would be to have the Priority Mail processed in-house without a network and that the Priority Mail Processing Center Network was not meeting overall delivery rate goals. Furthermore, the auditors reported that between November 1997 and August 1998 network subcontractors had abandoned Priority Mail bound for Alaska in Seattle, Washington rather than transport it to Alaska as required in the contract. This meant the Postal Service was incurring the costs of transporting the mail to Alaska rather than the contractor. A later audit report in September 2001 reported that security screenings performed by the contractor were not adequate, did not meet the contract requirements and that prior employment checks were not always performed.

On November 3, 2000 the Postal Service and Emery agreed to an early end to the contract. This followed a drawn out disagreement between the Postal Service and the contractor over the compensation under the contract. Emery's proposed rate was 40 percent higher than the Postal Service's estimate. The Postal Service assumed direct operating responsibility of the Priority Mail Processing Centers starting January 7, 2001 and has transitioned to using its own union workers to staff those facilities. In addition, the Postal Service has paid \$66 million to reimburse Emery for termination costs under the contract. In September 2001, the USPS paid Emery \$235 million to settle claims relating to alleged underpayments not related to termination costs. Additionally, Emery filed a further settlement proposal on December 14, 2001 for recovery of costs of providing service under the terminated contract by itself and its contractors. CNF reports \$5.7 million in settlement payments from the Postal Service in its fourth quarter 2002 results. 19

Mail Transport Equipment Service Centers

Another decision by the Postal Service to move work being performed in-house to contractor facilities involved the Mail Transport Equipment Service Center Network. This is a centrally managed system of 22 contractor operated equipment service centers

¹⁹ CNF Inc. 10-Q report filed with the SEC on September 30, 2002 and CNF report on fourth quarter 2002, January 27, 2003.

designed to supply mail processing facilities with the containers needed to process the mail. In 1997, the Postal Service prepared a Decision Analysis Report (DAR) to support a \$1.3 million capital investment to implement the contractor-operated systems as a replacement for the Postal operated system. The project was begun in November 1997 and completed in 1999.

The Office of the Inspector General of the Postal Service has done a series of reports on this system. ²⁰ An audit determined there had been several underestimates of contractor costs in the DAR and that the 10-year forecasts for the new system exceeded the old system by more than \$1 billion. Other analyses of the DAR for the project, found several mistakes in the calculations that had increased Postal costs compared to those of the contractors. Those ranged from overly high estimates of servicewide costs to incorrect formulas used in calculating capital costs.

In addition to the problems with the original DAR, the document that is generally used as the basis for making a decision about the proposed work, the IG's office has identified other operational problems with the contracts. Those included work that was invoiced as processed but the work was not performed, containers reported as repaired when no repairs were made, serviceable equipment condemned and discarded and poor record keeping that resulted in the Postal Service paying for work not properly authorized. Questions were also raised about the noncompetitive nature of some of the awards that had been made. ²¹

Efficiency questions have also been raised about whether a dedicated transportation system for this system makes optimal use of transportation capacity. Under the Postal operated system, trucks delivering equipment to user facilities returned with mail or frequently moved mail and equipment at the same time. This changed when the MTEC

²⁰ Audit Report- Mail Transport Equipment Service Center Decision Analysis Report, Performance and Financial Benefits (TR-AR-01-003), May 4, 2001.

²¹ Adequacy of Mail Transport Equipment Center Network Internal Controls (TR-AR-01-001), October 31, 2000 and Contracting Practices for the Procurement of Mail Transport Equipment Services (CA-AR-01-001), February 27, 2001.

contractors began operating their own transportation fleet and left Postal Service trucks on regular Postal runs often used inadequately in one direction or the other. The IG's survey of 301 user facilities for the Mail Transport Equipment Service Center Network found that 18 percent of them had employees searching for equipment more than 6 hours per day and more than 16 percent of the facilities used unscheduled transportation to return equipment, and more than 13 percent of the facilities scheduled extra transportation to obtain equipment. This causes inefficient use of both Postal employees' time and of Postal owned transportation equipment. The Postal Service has worked to address many of the concerns brought up by the IG's audits. However, these findings reinforce the importance of full and fair analysis of proposed methods of achieving a goal.

Conclusions on Partnerships

Postal and private sector partnerships are not an automatic panacea for problems within the Postal Service. The Postal Service's goal, moving large volumes of mail throughout a complex network on a tight time schedule, often makes it difficult to mesh an outside contractor's system into its own in an efficient manner. In addition, a tendency to produce overly optimistic Decision Analysis Reports may lead to wrong decisions being made. The Postal Service should consider its options in achieving its goals. But in doing so it needs to make a careful analysis of the costs and benefits of entering into each partnership and only accept those that make good business sense, will not disrupt the main operation of the mail or jeopardize its security, and where the private sector partner is demonstrably more efficient.

Technology Challenges and Benefits

The Postal Service has expressed a fear for many years that electronic forms of communication will erode its mainstay First Class mail service to the point that it will be unable to cover the costs of the network it needs to provide service to all the residences

and businesses in the United States six days a week. Unfortunately, the timing and potential impact of the potential erosion have been difficult to project. In its 1976 Annual Report, the Postal Service stated:

In 1976, the Postal Service also took steps to try to insure its future viability by increasing its exploration of its possible role in the future world of telecommunications. There is little doubt that communications in the future will be closely tied to this technology, and the Postal Service is now studying the feasibility of the electronic transmission of both urgent and low time value matter from point to point, with hard copy delivery.

Since that statement was made, total mail volume has grown 125 percent and First Class mail has grown 95 percent.

Current Circumstances Vs. Longer Term Trends

With the current state of technology, there will be an impact on mail volume caused by the increased use of electronic alternatives. Such impacts have happened in the past when the price of long distance calls declined, when expedited delivery services came into being, when fax was commercialized. However, one must be careful not to equate every use of electronic communications with a mail piece being diverted from the Postal System. The tremendous growth in e-mail does not reflect a letter lost for each message sent, e-mail has increased total communications and has replaced telephone calls more than letter mail.

Consequently, the role of the mail in this new environment can not be discounted. It is still a reliable method of targeting advertising without being as intrusive as dinner-time telemarketing calls. Mail can provide synergies with other forms of advertising such as combined TV and mail campaigns or mail can provide new methods for e-commerce to bring people to their sites without having to depend on vagaries of the search engine. 22 The majority of people still see the mail as the most reliable and dependable way of

²² A January 15th, 2003 presentation entitled "Making Paper More Intelligent" by Maynard Benjamin and Jay Freitas at the Postal Rate Commission detailed many of these new technologies and how they have the potential to increase the synergies between paper mail and electronic. See guest lectures at www.prc.gov.

receiving and delivering their bills despite several years now in which electronic bill payment and presentment has been available. 23

Electronic options to some mail-related activities are becoming increasingly easier to use and will likely result in some diversion from the use of the mail. However, it is important not to attribute all the changes observed in mail volume to electronic diversion without a careful analysis. Certainly the most recent changes in mail volume must be analyzed against a broader range of factors.

Mail volume was severely hurt by four blows within months of each other in 2001. The first was the first recession the U.S. economy had seen in ten years. While the start of the recession has been officially marked as March 2001, the economy was already suffering the early pangs of that recession in late 2000. Second, were two postal rate increases in 2001, one in January and one in July. Price increases will almost always cause some temporary volume impact. The third blow was the terrorist attacks in September 2001, which exacerbated the economic downturn, shutdown mail transport by air for several days and more importantly virtually paralyzed business decision making as planners tried to make sense of a world with a new set of parameters. Finally, in early October 2001, the mail was used to kill. Anthrax laden mail, destined for newsmakers and government officials, killed several postal workers and patrons and spread fear of the mail throughout the U.S. This latter use essentially removed government mail from the mail stream in the short-run and substantially reduced the volume of mail flowing to and from government offices in the longer-run. 24 Mail volume was bound to be impacted by each of these factors and the combination of all of them in such a short

²³ A report released by TowerGroup ("Will EBPP Adoption Surge? Many See Obstacles" *American Banker* December 13, 2002.) indicates that 80 percent of households prefer to receive bills through the mail rather than online and 13 percent of households expressed no preference between ways of receiving the bills.

²⁴ Of course the Federal government was actively removing mail from the Postal Service network even prior to the anthrax attacks. For example, the IRS reported that it received 47 million electronically filed returns during the tax season in 2002 (and 85 million paper ones) and that 39.7 million people had chosen direct deposit rather than receive a check, a 17.5 percent increase from the previous tax-filing season. From IRS press releases IR-2003-6, January 16, 2003 and IR-2002-121, November 13, 2002.

period of time was bound to reduce volumes across the board. What is much more difficult is to determine how or when mail volume might begin to recover and the circumstances under which it might not recover.

Chart 4 shows the relationship of percentage changes in mail volume to percentage changes in GDP. As can be seen from the chart, the recession in the early 1990s was also accompanied by weak mail volume growth. The magnitude of this decline is larger but it is much more likely that the bulk of that decline is due to the string of events in 2001 than it is to due to electronic diversion.

One set of data indicating the most recent mail volume declines may be primarily a result of the weak economy is information on advertising. Standard (A) mail accounted for a significant part of the total volume decline, declining 0.2 percent in 2001 and 3 percent in 2002. However, Standard (A) mail did not lose its share of the advertising market when that happened. That is because all of advertising suffered during the recession. Newspaper, periodical, TV, and radio advertising all experienced declines during this period of time. Standard (A) mail is now beginning to show year-over-year growth, as are some of the other advertising media. This is one indication that the observed mail volume effects were related to the economic downturn. USPS package services have also shown declines during the past two years. However, UPS has also experienced declining domestic package volume in 2001 and 2002, delivering 3 percent fewer packages in 2002 than it did in 2000.²⁵ First class mail volume has yet to show a strong turn around although it did show a small year-over-year gain during the 2002 holiday season. This may reflect the lingering effects of a weak economy. First Class mail is primarily used by a mix of consumers and businesses and both are still showing caution in their actions.

Information on Electronic Trends is often Confusing

Part of the difficulty in the Postal Service, or anyone, being able to gauge the extent of actual and potential electronic diversion is the lack of consistent and accurate data on the type of transactions that could replace mail. One example of different data estimates is the seemingly straightforward question about the ownership of a personal computer

²⁵ UPS financial statements for calendar year 2002.

(PC) by households in the U.S. and the use of the Internet by those households. This set of statistics provides a basis for judging the availability of various types of electronic communications to the households. The Postal Service, in its annual *Household Diary Survey* collects information about PC ownership by households as does the Census Bureau. Based on the *Household Diary Survey* information 60.8 million households owned PCs in 2000 and 69 million households owned PCs in 2001, a growth of over 13 percent. While the Census Bureau found a similar growth rate when it did its survey in September 2001, it found a lower number of households owning PCs, 60.2 million. A similar difference in the number of households appears in estimates of the percent of households with Internet access at home. *The Household Diary Survey* indicates 61 million households had Internet access at home in 2001, an increase of over 24 percent from the 49 million the 2000 survey reported. The Census survey indicated that 53.9 million households had Internet access at home in September 2001, up about 24 percent from 2000. ²⁶ While both surveys show similar growth rates, the difference in the actual household counts, equal to 7-9 percent of total households, does make it difficult to determine the magnitude of behavior leading to potential diversion from the mail stream. ²⁷

The prior example looked at differences in what should be a relatively well-defined group of households. Most people will clearly understand questions about whether or not they have a computer in their household or have Internet access from that computer. Unfortunately, questions about electronic bill payment can be much more confusing for consumers to answer than are questions about having a computer in the household because there are now many types of electronic payments and not all of them replace mailed bill payments. For example, the Federal Reserve has recently reported a sharp drop in the use of checks and thus it expects to reduce its check processing capacity and employment. The temptation might be to immediately equate that decline in checks with an equal decline in mail volume. However, a more careful study of check use indicates that many of the checks that have been replaced with electronic means are those that used to be used in face-to-face retail transactions. The increased use of debit and credit cards has significantly reduced the number of checks being used to pay for purchases in grocery and other retail establishments.

²⁶ *A Nation Online: How Americans are Expanding Their Use of the Internet*, p. 3.

²⁷ The percentage increase in Internet access by households between 2000 to 2001 accords relatively well with a measure of at-home Internet usage that is used by USPS witness Peter Bernstein in his analysis of mail diversion from technology during the R2001-1 rate case (USPS-T-10). However, the difficulties of projecting the number into the future become clear when the 2002 projections in that testimony are compared to the actual 2002 numbers. Mr. Bernstein presents a table (Table 6, p 15) of active Internet users using the service from their homes in May of 1999, 2000 and 2001. Also presented on that table are projections of users for several years into the future. Those projections show an expected growth rate of 18.5 percent between 2001 and 2002 and an additional 14.1 percent between May 2002 and May 2003. However, when that May 2002 projection of 18.5 percent growth is compared to actual growth during that time period one finds the actual increase in at-home active users was about 3 percent (Nielsen/Netratings, Press release September 12, 2002.) While at work usage continued to grow at double-digit rates, bill payment would most likely take place from home because of its sensitive nature. The latest NetRatings report shows that in December 2002 the number of active Internet users at home had grown 4 percent from year-earlier levels (January 15, 2003 press release). Consequently, it is unlikely the 14.1 percent growth rate projected for 2003 will be realized.

One example of the wide range of estimates that can be found on the topic of electronic bill payment and presentment relates to two different estimates of electronic bill payment in 2001 that are reported in two separate Postal Service sponsored documents. The Postal Service's 2001 *Household Diary Survey* indicates that households were paying 42 million online bill payments per month in 2001, up from about half that in 2000. This is in sharp contrast to a Tower Group report cited by Postal Service witness Bernstein during the R2001-1 rate case which stated that 1.7 million households were receiving an average of 2 e-bills per month in 2001, for a total of only 41 million e-bills presented for the entire year.²⁸ One potential explanation for this difference is that the number of electronic presentments may be lower than the number of electronic payments. However, it points to one of the many difficulties in making a clear assessment of the information available and what it means for mail volume.

One thing that is relatively clear from the data is that electronic means of communications are becoming more widely used by all levels of society. However, some groups are better served than others. This points up the importance of maintaining a Postal Service that serves everyone in America. The highest computer use is among people with the highest incomes and the highest educational attainment. About 85 percent of adults with college degrees use computers either at work or at home whereas only 17 percent of adults with less than a high school diploma use a computer. About 80 percent of persons with families incomes greater than \$50,000 use computers compared with less than 45 percent of persons with family incomes less than \$25,000. The highest computer use is in the households of families with children, almost 80 percent have computers, and the lowest use is in non-family households where only 52 percent use computers. Internet usage varies in a similar manner to computer usage although a lower percent of households in each group tends to use the Internet. There is also a geographic difference in Internet usage by density of the area lived in. The highest Internet usage is in urban areas that do not correspond to central city areas, about 57

²⁸ *Direct Testimony of Peter Bernstein on Behalf of the United States Postal Service*, USPS-T-10, R2001-1 p. 22.

percent of individuals over the age of 3 in those locations use the Internet. The lowest usage is in the urban central city areas where slightly less than half of individuals are Internet users. Rural America falls between the two urban groups with about 53 percent of individuals in rural areas using the Internet. Internet use is the highest among Asian Americans with slightly over 60 percent using the Internet, white Americans follow closely with about 60 percent using it. Slightly less than 40 percent of black Americans use the Internet and only about 32 percent of Hispanics use it. 29

Postal Service has Made Good Use of Technology

The Postal Service, as a business, has also made good use of technology to reduce its costs. While some postal systems in other countries had to face privatization before substantial automation was introduced, the U.S. Postal Service has focused on modernization for decades. The Postal Service's goal in mail processing is to get as much volume as possible barcoded and sorted to delivery point sequence using its automated equipment. This is a combined effort by Postal customers who enter prebarcoded mail into the network and the Postal Service who, to the greatest extent possible, barcodes incoming unbarcoded mail. This produces an automated mail stream that reduces mail processing costs by reducing manual sortation both in the mail processing plants and at the offices where the carriers collect mail for delivery. A prebarcoded and presorted mail piece can also skip the preliminary incoming sortation and move directly to the secondary sortation. That saves some processing time, although the more automated the mail stream the less time is saved by skipping a sortation. Bar code sorters can process over 30,000 pieces of mail an hour at maximum capacity.

²⁹ A Nation Online: How Americans are Expanding Their Use of the Internet, U.S. Census Bureau, Feb. 2002. All data are from September 2001.

In 1971, 25 percent of the mail received a first handling via mechanized means, all of the remainder of the sorting was done manually. To process 87 billion pieces of mail required 277 thousand clerks and 45 thousand mail handlers.³⁰ Today, over 200 billion pieces of mail go through the Postal network every year which requires 257 thousand clerks and 59 thousand mail handlers, about 2 percent below the 1971 levels, with more than double the number of pieces of mail moving through the network.

The ZIP (Zone Improvement Plan) Code system was introduced in 1963. It was designed to improve letter processing by reducing the number of sorts that was required to get mail to its destination. It still forms the basis for the 11-digit delivery point code that is the basis for automated mail processing today. The ZIP code system also allowed a better method for using the mail as an advertising medium as it became easier to target mailings to consumers.

In 1972 through 1974, the Postal Service made \$2 billion in capital commitments, almost 3 times what it had invested in the prior 3-year period. One improvement during this time period was increased purchases of quarter-ton delivery vehicles as the motorization of delivery routes, previously walked, was accomplished and another was the first use of cluster boxes. However, mail processing improvements have always been a major focus for capital investment because it is an area where automation was clearly going to have dramatic productivity improvements and provide a significant payoff for the Postal Service.

In September 1988, at the National Postal Forum, the Postmaster General announced a plan to have virtually all letters and non-carrier route presort flats mail barcoded by the end of 1995. Between 1992 and 1995 the Postal Service deployed 3,600 pieces of automation equipment, transitioned itself and its customers from ZIP+4 barcoding to delivery point barcoding, and installed barcode readers on flat sorting machines and in bulk mail centers for parcel processing. By the end of 1995, the Postal

³⁰ This number is for all clerks, including those whose primary job would customer service at a post office rather than mail processing. However, the number of clerks involved in mail processing is not reported in 1971. Number of Employees Paid during pay period ended October 15, 1971, USPS accounting division.

Service had 67,000 city carrier routes delivering some volume of delivery point sequenced mail. ³¹ By FY2001, the Postal Service and its customers barcoded about 90 percent of letter mail, 132 billion pieces. Only 8 percent of letter mail was still processed manually in 2001. The optical character readers recognition rates have been improved to the point that 75 percent of handwritten addressed letter mail can be barcoded and entered into the automation stream. ³² Recently, the Postal Service reported that between 1993 and 2001, letter mail productivity increased 83 percent and that in the last two years, flat sorting productivity has increased 78 percent. ³³

Despite the fact that automation directly targeted their jobs, the American Postal Worker's Union (APWU) never stood in the way of automation although it has worked toward fair and equitable treatment of employees during periods when technological change has brought about tremendous transitional changes to mail processing and their jobs. The impact of automation on Postal productivity can best be seen by the sharp reduction in the number of mail processing employees needed to sort the mail. Chart 5 shows the substantial decline in the number of APWU employees doing mail processing from its peak in 1986 despite a increase in mail volume of almost 40 percent. However, even prior to 1986, the rate of growth in the number of mail processing employees was reduced due to the use of mechanized equipment to sort the mail instead of manual sortation from start to finish that was being done prior to the 1970s. The Postal Service's use of automation equipment to sort mail to carrier route sequencing also cuts the rate of growth in the number of mail carriers needed to take mail out to each of the delivery points. The delivery route sorting that takes place at the mail processing plants replaces manual sortation done by the carrier prior to going out on the street. Consequently, the goal of DPS is to have the carriers delivering mail most of the time they are working rather than sorting the mail in the office in preparation for delivering it. This has allowed

³¹ Corporate Automation Plan, May 1996, p. 2.

³² Comprehensive Statement on Postal Operations, p. 46.

³³ USPS News Today, February 6, 2003.

the mail processing workforce and the automated equipment to provide mail in a manner that allows a more efficient use of the Postal Service's carriers as well.

Along with using technology to sort the mail, the Postal Service is using technology to provide better service to its customers in other ways. Computer terminals used in post offices provide postal clerks with better tools to more quickly and accurately complete their jobs. The Postal Service has introduced a new type of barcode that allows mailers to track their mail as it flows through the Postal network. This new service, called CONFIRM, allows mailers to determine when their mail is about to be delivered so they can better staff call centers and prepare for return mail and it also allows them to track the payments that consumers are sending back to them. This information allows multi-media advertising campaigns to be better managed.

Investment has been vital to the productivity growth of the U.S. Postal Service and has allowed it to continue to expand its delivery points without increasing its stamp prices faster than inflation. It is important that the Postal Service does not short-circuit its abilities to improve productivity through investment. While a capital freeze may seem like a necessity to meet a budget crunch, it becomes shortsighted if it means that productivity improving investments, even ones as inexpensive and simple as cluster boxes, are not made. Consequently, the Postal Service must be wary of starving its infrastructure and thus reducing its ability to provide good service to its customers. If the Postal Service loses its ability to provide good service, that will be its downfall.