

**Before The
President's Commission On The United States Postal Service**

**Testimony Of James R. O'Brien
Director, Distribution & Postal Affairs
TIME INC.**

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Executive Summary

AOL Time Warner is concerned about the ever higher costs that the Postal Service incurs in handling Periodicals. Despite major efforts by mailers to workshare (i.e., do much of the sorting work ourselves and prepare our mail to make it easier for the Postal Service to do the rest), and despite the Postal Service's use of ever more sophisticated machinery, Periodicals costs have continued to climb for many years at rates much higher than the rate of inflation and much higher than the rate of increase in postal wages, as was illustrated in AOL Time Warner's earlier comments before this Commission. We are concerned that the Postal Service appears to follow a misguided strategy that relies too much on unproven technology, is too driven by the desires of equipment vendors, ignores some of the fundamental differences between flats and letters, and fails to address the fundamental management issues that are the root cause of its problems.

The Postal Service could reduce Periodicals costs and other flats costs by providing cost-based, bottom-up rate schedules. This testimony will explain and illustrate how current Periodicals rates encourage inefficient, costly mailing practices and how a bottom-up approach to rate setting would save costs by encouraging efficient practices. If costs by mailers were recognized more effectively in rates by reducing the degree of rate averaging and requiring high-cost mailers to pay rates that cover the costs their mail causes, there would be efficiency gains benefiting the Nation and all Periodicals mailers. High-cost mailers would find it in their best interest to prepare their mail in efficient ways, and their postage would decrease much more than any costs they incur to change their mail. At the same time, low-cost mailers would see rates that bear a closer relation to the costs of their mail. These things simply will not happen under the current rate structure – high-cost mailers are given no signals about the costs they are causing and no options relating to what they could do to lower those costs.

It is also essential that the Postal Service be more successful in adjusting its workforce, downsizing when necessary, in response not only to declining volumes but also to the great cost savings opportunities generated by increases in worksharing and advances in automation. Worksharing is an essential part of the relationship between mailers and the Postal Service, because there are some functions that mailers perform much more efficiently than the Postal Service.

Finally, this testimony will explain AOL Time Warner's considerable concern about over-reliance by the Postal Service on technological solutions. We will show that some of the claims

made before this Commission of recent large productivity gains in flats handling are grossly exaggerated.

Bottom-Up Pricing

Bottom-up pricing is an alternative approach to postal rate setting in general and Periodicals rates in particular that could be implemented, would drive significant costs out the system, and would benefit both the Postal Service and mailers.

The concept underlying bottom-up pricing is that everyone who sends mail through the postal system uses certain resources of that system and should pay for (the marginal cost of) the use of those resources. This approach requires, of course, that one know the marginal cost of each such resource. Although the Postal Service's cost-analysis capability leaves much to be desired, sufficient cost data already exist to make possible a significant move towards cost-based, bottom-up pricing.

Current postal rates include various discounts designed to encourage certain types of behavior. Except for the Periodicals editorial discount, these discounts are believed to promote mailer behavior that leads to lower costs. With a few exceptions, such as certain Periodicals and Standard flats automation discounts, they are believed to lower Postal Service costs by at least the amount of the discount. In addition to discounts, the Postal Service administers a complex set of regulations to control mailer behavior, so as to avoid particularly wasteful practices. Mailers must devote considerable resources to navigating through these regulations, which are far more complex than the rates themselves, and to keeping up with the never-ending changes.

Yet this system of discounts and regulations, intimidating by its complexity, permits many abuses and deprives both the Postal Service and mailers of many opportunities to reduce costs through more efficient mail preparation and entry.

Here is one example. Assume that a Periodicals mailer has 24 copies of a magazine or newspaper that he wants to mail to the geographic area served by one postal plant, called a sectional center facility (SCF). Such a plant might serve one medium-size city and its surroundings, or part of a large metropolitan area. Assume also that each of these copies is addressed to a different 5-digit ZIP code area served by that plant. Under the current rates and regulations, one alternative for this mailer is to place all the pieces in one sack and label it to be opened at the SCF. The sack will eventually get to that SCF, where it will be opened and the pieces dumped out. The sack will be put aside for recycling and eventual use by another mailer.¹ The pieces will be sent to a flat sorting operation. Typically, this operation (called incoming primary sort) will be performed on an automated sorting machine (AFSM-100) that sends each copy to a container for its proper 5-digit zone. The copies for a given zone will then be sorted to carrier route and eventually will be given to the carriers who are going to deliver them.

However, Periodicals mailers know from experience (and subscriber complaints) that this process sometimes involves considerable delays and that the magazine might get to the

¹Sacks and pallets used to enter mail are Postal Service property. After each use they are returned to mailers to be used again. Sack and pallet charges could therefore be considered rental fees.

subscriber when the news it carries is no longer news. They also know that, due to the way the postal network functions and the peculiar way that current regulations are written, they are likely to get faster delivery by putting each copy in a separate sack labeled to the 5-digit ZIP code that that copy is addressed to. The postage will be the same, and the copies will, on average at least, get delivered faster. But the costs to the Postal Service, which now needs to handle twenty-four sacks instead of one, and ultimately to all Periodicals mailers, will be much higher. How much higher? The cost of sending one sack through the postal system (depending on how far it travels) is typically between two and four dollars, whether the sack contains one piece or fifty. So each of these pieces will cost the Postal Service at least \$2, just to process the sack the piece is transported in. Were the 24 pieces instead sent together in one sack, the Postal Service would have to do an extra flat sort, but such a sort only costs a few cents per piece.

When the possibility is raised of prohibiting inefficient mailing practices such as the one described above, many mailers, even very large mailers, put up strong resistance. They are accustomed to having these options, and most mailers, of course, have no idea of how much their practices cost the Postal Service.

Since the Postal Service does know how much it costs to handle a sack, why not simply charge a mailer for the number of sacks he uses, in addition to other charges related to piece count and weight? That would be an example of what we refer to as bottom-up pricing – charging for the resources used based on the cost of each resource. Under such a pricing regime, mailers would have the correct information and incentives to make rational choices. Some mailers might find it worthwhile to pay the cost of putting a single copy (or two or three copies) in a sack, in order to get faster delivery. But in most cases the practice would simply disappear, along with substantial costs that the Postal Service now distributes among all Periodicals mailers.

The Postal Service has known for many years that sacks are expensive to handle and that flats costs much less when they are instead entered on pallets. It has therefore encouraged Periodicals and Standard mailers to enter their flats on pallets, and well over half are entered on pallets today. But a large number of costly sacks remain in the system because the incentives for palletization fall far short of the benefits in reduced costs to the Postal Service. In the latest rate case (R2001-1), for example, the Postal Service introduced a small discount (half a cent per piece) for Periodicals entered on pallets, the objective being to discourage the use of sacks and thereby save costs. But the type of discount offered is unlikely to help much. Consider again the sack with a single magazine or newspaper. The incentive that the discount offers for eliminating this sack is exactly one half cent. If the same sack contains 50 copies of a magazine or newspaper, the incentive for eliminating it is 25 cents. As a result, the sacks that are most likely to be removed from the system by this type of discount are the ones whose costs are least disproportionate to the amount of postage they pay. How much more effective the pricing system would be in promoting rational economic behavior if mailers simply were charged a realistic price for each sack, or alternatively each pallet, that they use.²

² For example, a USPS study performed about three years ago showed that a carrier route presorted bundle that is entered on a 5-digit pallet costs, on the average, 54 cents for the bundle plus two cents per piece less for the Postal Service to handle than if the bundle were entered on an ADC pallet. Yet there is no difference in rates. Mailers therefore have little incentive to present more finely presorted pallets, even

This example of the superiority of a bottom-up pricing system is in no way anomalous or singular. Consider another example, Periodicals and Standard flats are typically entered in presorted bundles that are labeled and placed either in sacks or on pallets. The Postal Service incurs considerable costs in sorting bundles and then cutting the bundles open to prepare the pieces for piece sorting. Sorting a bundle generally costs less than it would to sort the individual pieces inside the bundle. But Postal Service regulations impose minimums on the number of pieces (copies) in a bundle that are not founded in rigorous cost analysis and do not lead to optimal (i.e., cost minimizing) mail preparation. Rates would be more efficient if there were cost-based charges per bundle and per piece. Minimums would be unnecessary, because mailers would quickly figure out which levels of bundling minimize their total rates (and the Postal Service's total costs).

Consider one last example. The Postal Service incurs substantial costs in forwarding undeliverable as addressed (UAA) Periodicals. It has imposed various, often changing, regulations related to the quality and updating of subscriber addresses. What if instead it simply measured, as it has the ability to do, the amount of forwarding performed for each Periodical and then charged the mailer the costs? Mailers would then have an informed choice to make: the more frequently they updated their address data bases and the more effort they put into address quality efforts, the lower their postal rates would be.

The Postal Service's costing data are far from perfect. But they include much cost information that if properly used in rate setting would provide mailers with much better price signals than is the case today. The Postal Service already has considerable data not yet used in rate setting on the unit costs of each piece, bundle, sack and pallet, as well as on how those unit costs vary with presort level, proximity of entry facility to final destination, etc. This information can and should be used to build bottom-up, cost-based rates that would give mailers correct price signals, require fewer bureaucratic regulations, and help drive costs out of the system.

Those in the Postal Service who have actually studied these issues know that this is the correct direction for rate making. We hope this Commission will analyze carefully why the Postal Service seems institutionally incapable of taking the steps necessary to implement a rational rate schedule.

Worksharing and Automation

The rationale of worksharing is that the mailers should do the work that they can do more efficiently than the Postal Service. As to what we the mailers can do best, consider that before an issue of a magazine such as TIME is produced, we already know exactly how many copies will be mailed, how much they will weigh, and the post offices and the carrier routes from which each copy will be delivered. So we are able to do most of the sorting that is necessary in a computer, before the magazines are even printed. No sorting machine the Postal Service acquires in the future, no matter how fast, will be able to sort the physical copies as rapidly or as cheaply as they can be presorted electronically by a computer. In the case of TIME magazine,

though the savings to the Postal Service could be substantial. Of course, there are also costs associated with handling more pallets. But with cost-based charges for each pallet used as well as each sack used, together with cost-based incentives for finer pallet presortation, mailers would quickly figure out the appropriate balance that minimizes their overall costs.

about 88% of the four million copies mailed each week are produced in carrier route bundles that can be taken directly to the individual carriers. Within each such bundle the copies are arranged in the sequence in which they will be delivered by the carrier.

Almost all copies of Time Inc.'s more than forty Periodicals that are not carrier route presorted are barcoded to make sorting as easy as possible for the Postal Service. We also spend a great deal of effort and money on address quality, which means assuring that every address in our data base is updated and conforms to the Postal Service's addressing standards.

A magazine like TIME has many thousands of different "versions." Even within a given carrier route bundle, there may be many versions of the magazine. The reason we are nonetheless able to achieve such high levels of presort is that some years ago we and our printers invested many millions of dollars in a technology called "inline selective binding." Today, printers use a similar technology to achieve high levels of presort even for magazines with low circulation, by bundling several of them together in a process called co-mailing.

Almost 50% of all the flats that the Postal Service delivers are carrier route presorted, meaning that postal clerks do not need to do any sorting of those flats. This is one way in which flats differ significantly from letters. Before the Postal Service started delivery point sequencing of letters, the volume of carrier route presorted letters was quite low. If the Postal Service goes ahead with its most far-fetched technological solution – which contemplates either the sorting of all flats into delivery point sequence (DPS), or even of all flats and letters into a single delivery point package (DPP) – the large sunk investment by Periodicals and Standard flats mailers in carrier route presorting will be worthless. All these flats that today can be taken directly to the local delivery units will have to be processed at large plants. Flats are much bulkier than letters, and it does not appear that anyone at the Postal Service has done any rigorous calculation of how much today's processing plants would have to be expanded if all the flats that today bypass the plants or are just transferred there at the platform were to require extensive processing on the new machines the Postal Service wants to buy to do flats delivery point sequencing. We suspect that they might need substantial expansion.

We are therefore highly skeptical about the Postal Service's plans for total flats automation and claims that those plans will reduce costs. It is possible, of course, that when the Postal Service has all its desired technology in place it will be able to process at lower costs those flats that enter the system with little or no presort (e.g., most First Class flats.) But it is doubtful that new technology will also lower the costs for our current carrier route flats. Moreover, it might lead in many cases to slower delivery.

The Postal Service has produced nothing approaching a rigorous analysis of how the technological solutions it is discussing with equipment vendors would affect costs. Nor has it produced any analysis of the likely impact on service or on the substantial volume of today's carrier route presorted flats that probably will not fit any type of sorting machine and might end up leaving the postal system altogether.

Even if the Postal Service eventually produces estimates projecting savings for the currently carrier route presorted flats, we would likely remain skeptical. The Postal Service has a long history of exaggerated claims regarding automation-related savings. Both before-the-fact

projections and after-the-fact “measurements” have consistently (for nearly 20 years) substantially exaggerated improvements in mail processing productivity generated by the introduction of new technology. The reason for these disappointing results has been management’s consistent failure to achieve the kind of workhour reductions that the increased sortation capacities of new technologies ought to have made possible.

The Commission need not seek far to find an illustration of this tendency to exaggerate the savings derived from new technology. Both the Postal Service and the President for APWU have boasted of a recent two-year increase of 78 percent or more in “flat sorting productivity.”³ Ninety-nine people out of a hundred would probably interpret those statements as meaning that in those two years mail processing productivity for flats had improved, maybe even that it had improved by 78 percent. In fact, the per-piece cost the Postal Service attributes to mail processing of Periodicals increased by 7.62% in FY2001. In FY2002 it declined by 2.8%, for a combined increase in those two years of 4.61%. That is less than inflation in wage rates over the last two years, but certainly not a 78% overall productivity increase. If one looks more carefully at the statements that evinced such a rare, pleased unanimity from USPS managers and APWU leaders, one will notice that their claims referred only to flats sorting productivity, not to other operations involved in flats processing or to flats processing as a whole. One might also notice, as can be discovered from a careful reading of only some of these statements, that they refer only to sorting of flats performed in processing plants, not to the very substantial portion of flats sorting still performed manually in the local delivery units. What one would not be able to notice, because it is nowhere stated, is that the Postal Service has changed the definition of flats sorting, so that some of the preparatory work (often called allied labor) that previously was performed by sorting clerks and classified as “sorting” now is performed by other employees and no longer classified as “sorting,” although it is still charged as an attributable cost to the same flats as before.⁴

There is little doubt that the new flats sorting machines that the Postal Service deployed in FY2001 and FY2002 are vastly superior to the older machines that they replaced and may have helped produce some real productivity gains. But the Commission should be aware that for many years, since roughly FY86, Periodicals mailers had to watch, year after year, the surprising combination of: (1) more and more advanced machines which it was assumed would reduce processing costs; (2) mailers doing more and more of the mail processing themselves, through worksharing; and (3) Periodicals unit mail processing costs still increasing much more rapidly than the rise in postal wage rates.

It is not difficult to explain this seeming inversion of economic logic, although the Postal Service officially has always denied the obvious explanation. Employees whose time was freed up by automation and by mailers doing more of the work did not just disappear. They remained in the postal facilities, but in need of new assignments. Postal managers apparently hoped that

³ See USPS, “The Future of flats Processing,” Memo to Mailers (April 2003), at 3; William Burris, Testimony Before the President’s Commission on the United States Postal Service, April, 29, 2003, at 2.

⁴ In FY2001 and again in FY2002 the weight of an average Periodicals piece declined, due mostly to reduced ability of publishers to sell advertising space. Weight affects the cost of processing, exactly to what degree is not fully understood, but the reduced weight should also in itself have reduced the per-piece Periodicals processing costs.

increasing volume would help produce enough new work to keep these “automation refugees” busy. But in any event, facility managers like having more employees available during peak periods, because it helps them raise their well publicized First Class overnight delivery score, a key element in determining their evaluations and bonuses. In fact, facility managers have few if any incentives to try to get by with fewer employees, and considerable disincentives to doing so. Reductions in workhours reduce the baseline for their future budget requests and are hardly conducive to smooth relations with, and evaluations from, labor. Moreover, as in bureaucracies generally, a manager's relative importance in the scheme of things tends to be judged by the size of his establishment. The Postal Service desperately needs strong, positive incentives for management and labor alike to reduce costs without degrading quality of service.

The Commission has heard a great deal, and will no doubt hear more, about dramatic productivity gains, in the tens of billions, that could be achieved in 3, or 5, or 7 years if only USPS is willing to make large capital investments in as yet undeveloped technologies. In evaluating those claims, it is essential to remember that those billions promised to be saved consist almost entirely of the costs of currently employed postal labor, and that it is the managers, not the new machines, that will have to make the workforce reductions necessary to realizing the promised increases in productivity. If, as is currently the case, postal managers have no incentives to take such necessarily challenging, disruptive, unpleasant steps, a primarily technological “fix” for the Postal Service’s problems, like past investments in technology, is preordained to fall well short of expectations.