

## **Final Comments to the President's Commission on the United States Postal Service**

Earlier this year the Magazine Publishers of America (MPA) submitted to the Commission written and oral testimony on a broad variety of topics. Since then there has been heightened scrutiny and debate on many issues. We believe the record on at least four of them, “standardization,” “pricing flexibility,” “cost attribution,” and “retained earnings” is incomplete. Therefore, we appreciate this opportunity to submit additional comments.

### **Standardization**

The term standardization has been used broadly during the Commission’s proceedings to describe many efficiency-enhancing initiatives. As a general proposition, MPA supports “standardization” initiatives that drive costs from the system, including standardizing operating procedures, rationalizing the processing network, aligning mail preparation with postal operations, automating mail processing, and replicating best practices across the nation. As we said in our initial Comments:

We acknowledge that standardization and automation are laudable goals but believe that the Postal Service must not lose sight of its obligation to deliver the broad variety of mail that consumers wish to receive. . . .[W]e recommend continuation of the Postal Service’s statutory monopolies. We believe that with this monopoly comes the responsibility to accept and deliver the broad variety of mail that publishers (and other mailers) want to send and that, in fact, their recipients desire. Publishers use the Postal Service to distribute a broad spectrum of magazine formats – ranging from ounces to pounds; from digest size to tabloid size; from unwrapped to polywrapped. This variety should be embraced, not shunned. The Postal Service must retain the flexibility to accommodate mail of all shapes and sizes.

With the above caution, we stress the value of operational standardization. For example, after a period of rapidly escalating costs for periodicals and other flat-shaped mail, several initiatives that fall under the standardization umbrella have begun to achieve significant productivity improvements for periodicals. Through a Mailers’ Technical

Advisory Committee (MTAC) workgroup, MPA members are working collaboratively with the Postal Service to design a new container for flats that would replace bundles. Use of the container would “standardize” the induction of flats and enable them to flow seamlessly from our printers to postal automation. Given that unbundling flats and prepping these pieces for automation accounts for about one-third of the Postal Service’s cost for automated processing, developing a new container could improve the efficiency of existing postal automation dramatically.

MPA has also worked collaboratively with the Postal Service to resolve a serious difficulty with its automated equipment – newly installed high speed feeders were tearing the covers off some flats. The permanent solution will be a retrofit of the machines, which the Postal Service is now undertaking. In the interim, machine operators have been provided additional training on correct “feeding” procedures and mailers have undertaken additional measures to secure covers.

There is significant opportunity to improve postal operations through these forms of standardization. We are also confident that the Postal Service will be able to significantly reduce its costs through its Network Integration and Alignment (NIA) initiative, which is aimed at rationalizing its processing network.

We must, however, reiterate our reservations about the Postal Service, under the guise of standardization, imposing restrictive regulations pertaining to what can be mailed. In comments recently filed with the Commission, the Mailers Council addressed the issue of whether the Postal Service should impose more restrictive requirements regulating the size and shape of mail pieces. MPA agrees with the Mailers Council’s position that doing so would hurt, not help, postal financial performance. An appropriate balance between rigidity and flexibility must be maintained. To the greatest extent possible, the intercourse between the USPS and its customers should be viewed as a business relationship, not a regulatory regime.

Due in large part to the cooperative efforts of the USPS and mailers, significant strides toward more efficient operations have been made in recent years. Because of opportunities created by technological advances, and concomitant rate and service incentives, most mail is now standardized to a sufficient extent; in fact, 90 percent of flats are currently processed on Postal Service automation equipment. Over the past two

years, the Postal Service has increased its flat sorting productivity from under 600 pieces per work hour to nearly 1,000 pieces per work hour.

The businesslike "partnership" approach to enhancing USPS efficiency is working. In our view, imposing additional standards would at best yield only marginal improvements in efficiency, at too high a cost. Restricting mail piece design would reduce the value of mail, thereby reducing mail volume and postal revenue. As the Mailers Council accurately noted on this point, "mailers are often able to gain their customers' attention because of the attractive and creative mail piece design. This opportunity to display creativity, in ways that can involve unique (and perhaps nonstandardized) designs, is the primary reason why many mailers that are marketing a product choose to do so using the Postal Service. If you remove the opportunity for designing a unique mail piece, the mailer will seek another marketing channel, and postal revenues will decline."

Having the flexibility to produce an attractive and creative mail piece is at least as important for magazines as for other mail. Unlike mail used to market a product, publishers mail their actual products – magazines. Since subscribers purchase magazines for their unique designs (including trim size, cover design, and thickness) as well as their content, altering mail piece designs in a way that stifles creativity would inevitably lead to losses in subscribers. Furthermore, since magazines that are mailed to subscribers must offer similar material and value-added items to those that are sold on newsstands, flexibility in mail piece design is even more important. Similarly, restricting mail piece design would hurt customer service. For example, for the customer's convenience, publishers often mail renewal notices in polywrap with the magazine. Limiting the ability of publishers to do so would reduce the service publishers provide their customers.

Losses in number of subscribers would harm the Postal Service in addition to our industry. Fewer subscribers would reduce mail volume across all major classes of mail since publishers use the Postal Service to send bills, renewal notices, promotional pieces, and premiums as well as for the delivery of magazines. Reductions in magazine subscriptions would also reduce the value of mail as a whole. As we noted in our earlier comments to this Commission, "former Postmaster General William Henderson likened the place of magazines in the mailbox to the place of the 'anchor store' in a mall – the

reason people go there. Magazine publishers need the Postal Service and the Postal Service needs magazines.” Furthermore, because publishers pay both a piece and pound charge for mailing magazines, restricting mail piece design and, in particular, limiting the thickness of magazines would immediately lower Postal Service revenue from Periodicals.

Finally, along with the Postal Service’s statutory monopoly come responsibilities. Near the top of these responsibilities, as we noted in earlier comments and above, is one to accept and deliver a reasonable diversity of mail. Discouraging the distribution of magazines through mail piece design restrictions would be particularly troubling since “facilitating nationwide distribution of the printed word was a fundamental justification for the original establishment of America’s government-sponsored postal system.”

While, for the reasons discussed above, the Postal Service should not impose blanket changes to mail piece design standards, we understand that the Postal Service may want to make individual, minor modifications to them. In such situations, we believe that the Postal Service should be required to perform a cost-benefit analysis along the lines discussed in the study by Global Insight to justify the changes. As Global Insight noted in its recent report to this Commission:

To understand the incremental cost reductions that might be available through mail piece standardization and the potential costs to future mail volume, there is a need for engineering analysis that has not been done by the USPS or the customers. Specific machine operating standards would have to be specified. The pieces in the current and potential future mailstream that would be affected would have to be identified and potential revenue impacts could be estimated.

### **Costing, Pricing, and Pricing Flexibility**

There seems to be much support for providing additional “pricing flexibility” to the Postal Service. We support this and have said so in previous comments: “A new pricing system is needed to increase the Postal Service’s managerial discretion, drive costs from the postal system by encouraging cost-efficient practices, and reverse the trend toward large and unpredictable rate increases.” We have coupled our support, however, with caution that the new pricing regime must take into account America’s long-held postal policy that recognizes the historic role of periodicals. We stressed that any such regime should continue existing law’s recognition of the educational, cultural, scientific

and informational value (ECSI) of periodicals. Thus, we are concerned that the May 29 testimony of the Postmaster General could be construed to suggest abandonment of that long-held policy, and, perhaps, abandonment of necessary protections to ensure that “captive customers” are not disadvantaged.

The Postmaster General testified that the Postal Service "should have the latitude to charge value-based prices, that is, prices based on the value of the service within the marketplace." We know that the current Postmaster General has only the best of intentions. However, while giving the Postal Service such pricing latitude may be reasonable for mail classes where rates are constrained by competitive pressures, granting the Postal Service such pricing flexibility for mail where there are no alternatives could allow the Postal Service at some point in the future to use its monopoly power to gouge its captive customers. This is the case with periodicals, 85 percent of which are delivered through the mail. We oppose granting the Postal Service unfettered pricing flexibility such as that suggested by the Postmaster General. In our initial Comments we explained how the Postal Service could be given needed pricing flexibility while still ensuring rate stability and predictability:

One way in which rate stability and predictability could be achieved, while still allowing the Postal Service increased flexibility, is through a system that automatically constrains rate increases at or below the level of inflation (e.g., an indexing system implemented at the subclass level), while allowing the Postal Service the managerial flexibility to price its products and services within those limits. If such a system were implemented, rate regulation could be significantly simplified, efficient Postal Service management practices encouraged, and the scope and timing of rate increases made more manageable. The Postal Service would have considerable discretion in pricing its products and services under such a system, but would always have to manage the overall business with the index in mind. Rate regulation in such a regime could be structured around a complaint-based review system, whereby rate or service complaints could be lodged with the regulator and dealt with promptly.

We note that a pricing regime that also provides for negotiated service agreements and specialized niche classifications to enhance the value of mail and encourage worksharing is consistent with the necessary constraints we recommend to protect captive customers while providing the Postal Service additional pricing flexibility.

We would also like to comment on presentations to the Commission that have extolled the virtues of Activity Based Costing (ABC) as a way to raise the attribution levels of Postal Service costs for purposes of setting postal prices. It may seem axiomatic that a firm should be able to identify all of its costs and allocate or attribute them accurately for purposes of setting prices. Clearly, at least one industrial engineer who testified before the Commission believes so. We, however, are steeled by years of litigation experience in measuring and attributing postal costs and applying them for pricing purposes. The task is not as simple as some would have us think. In these comments we present accounting and economic literature that shows why attributing all costs to products using ABC techniques is incorrect and that the original proponents of such an approach have acknowledged this and have recanted.

In their working paper, “Coverage of Criticism of Activity-Based Costing in Canadian Textbooks”, Beaulieu and Lakra succinctly describe the theoretical criticism of Activity Based Costing:

Noreen (1991) identified three necessary and sufficient conditions for the relevance of activity-based costs; a relevant allocation of cost was defined as one that represents avoidable and incremental activity costs. The first condition is that total cost can be partitioned into cost pools, with each pool depending on only one cost driver. Second, costs in each pool must be strictly proportional to level of activity; cost functions that are nonlinear or have nonzero intercepts are excluded. Third, activity measures used to assign costs to individual products can be summed to calculate total activity. This condition excludes all types of dependencies between products, whether they are called synergies, interactions, joint processes or common costs. Noreen’s point is that these conditions, particularly the second and third, must be satisfied in order for ABC numbers to be relevant, even though they are very strong. **No subsequent research has directly challenged Noreen on these three conditions.** (emphasis added)<sup>1</sup>

It is obvious that the assumption of proportionality between costs and activity levels is not correct for many industries including the Postal Service: any industry with either economies or diseconomies of scale violates the assumption and industrial organization economists universally believe that many industries (including the Postal Service) exhibit these traits. In fact, in the two most recently litigated Omnibus Rate Cases where there

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<sup>1</sup>Beaulier, P. and A. Lakra. 2003. Coverage of Criticism of Activity-Based Costing in Canadian Textbooks, Working Paper.

has been much controversy over the variability of mail processing costs, United Parcel Service witness Kevin Neels<sup>2</sup> specified nonlinear cost functions for mail processing. Further, the literature shows several tests of the proportionality assumption for overhead and indirect type costs and each failed the test. A study of overhead costs at hospitals using cross sectional data<sup>3</sup> showed that they were not proportional and an analysis of indirect production labor costs at a manufacturing plant using time series analysis<sup>4</sup> also showed that they were not proportional. Finally, a study of Selling, General, and Administrative costs of 7,885 firms over 20 years<sup>5</sup> showed that they were not proportional.

It is equally clear that the third condition is also not correct for the Postal Service. All observers concede the existence of common costs and there are clear synergies and dependencies between products.

These criticisms of ABC have led its proponents to significantly revise their views:

Defending ABC against general academic criticism...led to Kaplan and Cooper redefining their concept of resources and creating a model of cost hierarchy. This entailed the abandoning of some of the key simplicities of first-wave ABC – "allocation" was replaced by "estimation", "accuracy" was redefined as subjective judgment rather than objective fact, **certainty over the variability of "almost all" costs became an extended taxonomy of fixed costs**, and the determination of product costs moved from the center stage to a neglected peripheral position. Thus the change in Kaplan and Cooper's ABC cannot be described as a refinement or development of their original propositions. Much of the first-wave ABC was jettisoned and wholly new elements were inserted. Second-wave ABC represented a quite different accounting – one which was a contribution margin approach rather than an absorption costing system. (emphasis added)<sup>6</sup>

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<sup>2</sup> PRC Docket No. R2000-1. Testimony of UPS Witness Kevin Neels (UPS-T-1); PRC Docket No. R97-1, Testimony of UPS Witness Kevin Neels (UPS-T-1).

<sup>3</sup>Noreen, E. and N. Soderstrom. 1991. Are overhead costs strictly proportional to activity? Evidence from hospital service departments. *Journal of Accounting and Economics* (17): 225-278.

<sup>4</sup>Banker, R. D., G. Potter, and D. Srinivasan. 2000. A Time-Series Analysis of Indirect Production Labor Costs. [http://www.utdallas.edu/~rbaner/Time\\_Series\\_Anal.pdf](http://www.utdallas.edu/~rbaner/Time_Series_Anal.pdf).

<sup>5</sup>Anderson, M.C., R. Banker, and S. Janakiraman. 2000. Are Selling General, and Administrative Costs "Sticky"? [http://www.utdallas.edu/~rbaner/Final\\_Sticky%20Costs1.pdf](http://www.utdallas.edu/~rbaner/Final_Sticky%20Costs1.pdf).

<sup>6</sup>Jones, T. C. and D. Dugdale. 2002. The ABC Bandwagon and the juggernaut of modernity. *Accounting, Organizations and Society* (January/March): 121-163.

Thus, the current best-practice application of ABC recognizes that not all costs can properly be attributed to products. For example, a Rand paper on ABC identifies four cost categories – (1) Facility-sustaining activities, (2) Product-sustaining activities, (3) Batch-level activities, and (4) Unit-level activities. The paper continues: “In undertaking an Activity Based Costing analysis, Cooper and Kaplan caution that managers must carefully distinguish the costs that fall in each category and refrain from allocating facility, product-sustaining and batch-level costs to individual units.”<sup>7</sup> So Cooper and Kaplan, the original proponents of ABC, would now disagree with the concept of using it to raise attribution levels by allocating all USPS costs to individual mail pieces.

### **Retained Earnings**

Several parties have suggested that the Postal Service’s break-even mandate be “put aside.” The Postmaster General recommended that “[i]nstead, the Postal Service should be allowed to retain earnings from year to year. In a businesslike manner retained earnings could be used to bridge economic slowdowns and to invest in new technologies and infrastructure.” As the Commission considers this issue, we note once again that the ability for the Postal Service to retain earnings if coupled with unfettered pricing flexibility such as that suggested by the Postmaster General (and discussed above) would create an unacceptable opportunity for the Postal Service to take unfair advantage of its de jure and de facto monopoly customers.

We have one additional concern regarding retained earnings. As we said in our initial Comments, “[a]s long as the Postal Service retains its monopoly, there is a risk that service could be reduced below acceptable levels without any alternative for mailers in monopoly and noncompetitive classes.” A “profit” incentive, such as retained earnings, could drive postal managers to seek unacceptable reductions in service. To ensure this does not happen, we reiterate that “we believe it is crucial that the Postal Service and its regulator create a system of measurable service standards for all classes of service (today only First-class service is measured) . . . Mailers need a reliable postal system, with

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<sup>7</sup>Keating, E. and S. Gates. 1999. Defense Working Capital Fund Pricing Policies: Insights from the Defense Finance and Accounting Service. Rand Corporation Document No. MR-1066-DFAS. Appendix D.

clearly articulated service standards, and avenues of recourse if the standards are not met.”

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In summary, MPA is supportive of many initiatives related to standardization. We, however, have serious reservations with the Postal Service imposing blanket restrictions on mail piece design. In fact, we believe that doing so would harm the Postal Service, not help it. In addition to being a bad business decision, placing restrictions on what can be mailed is contrary to the Postal Service’s responsibility to accept and deliver a reasonable diversity of mail. For these reasons, we believe that the Postal Service should not make wholesale changes to mail piece design standards. In situations where the Postal Service believes that minor modifications to standards would be beneficial, it should justify the change through a thorough cost-benefit analysis. MPA also supports additional pricing flexibility for the Postal Service, again with reservations that any new pricing regime must take into account the Postal Service's de jure and de facto monopoly position as well as uphold the long-held national public policy concerning the historic role of periodicals by recognizing existing law’s recognition of the educational, cultural, scientific and informational value (ECSI) of periodicals. Finally, if the Postal Service is permitted to retain earnings it is imperative to ensure that the interests of “captive customers” are adequately protected and that measurable, meaningful, and enforceable service standards are established and maintained for all classes of mail. We hope the Commission finds our perspectives on these issues helpful.