TESTIMONY OF
Gary M. Mulloy
Chairman & CEO

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

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Contents:

For further information contact:
Vince Giuliano, SVP Government Relations
ADVO, Inc. / One Univac Lane / Windsor, CT / 06095
Phone: (860) 285-6126 Fax: (860) 285-1567

Statement of Gary M. Mulloy

My name is Gary Mulloy and I am Chairman and CEO of ADVO, Inc. ADVO is the largest full-service targeted direct marketing services company in the United States. Our shared mail advertising programs reach 65 to 102 million U.S. households on a weekly and monthly basis. We service more than 26,000 customers and distribute more than 28 billion pieces of advertising on their behalf. In 1985 we launched the "America's Looking for its Missing Children Program" in Partnership with the National Center for Missing and Exploited Children and the U.S. Postal Service. Our program has been extremely successful and has led to the safe recovery of 126 Missing Children. Our "Have You Seen Me?" card is considered the most recognized piece of mail in the country.

Thank you for giving me this opportunity to testify and for your work to ensure the long-term viability of the U.S. Postal Service.

Your invitation requested that my testimony focus on what steps the Postal Service should take to control its costs. I submitted my suggestions last week and won't repeat them today other than to note that continual cost containment and productivity improvements are essential hallmarks of successful businesses today. The Postal Service must continue these efforts on an ongoing basis if it is to be commercially successful. I would note, however, a major distinction between cost control and containment and cost cutting. Cost control will not by itself ensure the long-term viability of any commercial entity, including the Postal Service. Indeed, cost-*cutting* will undermine economic strength if it leads to reductions in service or to an ill-advised rush to automation that pushes mail out of the system. Like any commercial entity, to achieve long term viability the Postal Service must grow volume and top line revenue, an achievable goal even in today's challenging competitive and economic environment.

ADVO is committed to doubling its business in the next five years because we see tremendous potential for growth in print advertising delivered directly to consumers' homes. Currently, half our top line revenue (half a billion dollars a year) covers our postal expense, and I believe that the Postal Service can and should be our partner in this significant growth. However, ADVO is prepared to grow without the Postal Service if its economics and service are unattractive to our clients. In fact we are actively developing alternative delivery options because of our need to protect our shareholders from a concern that the economics and service of the Postal Service may erode in the future. Currently 7% or more than 200 million pieces per year of our product are delivered through these alternative methods vs. less than 3% just five years ago.

Many of our 26,000 clients are small businesses and our service is the best method they have available to generate store traffic and sales so that they can pay their employees and support their families. While competitors describe our product as "junk mail," this Commission and the Postal Service should call it advertising mail, the driver of business and revenue for large and small businesses across America. It allows businesses to tell their story to consumers and compete in the retail marketplace in an economic and affordable way. Consumers value this mail as is evidenced by their high readership and response. However, the primary evidence of this value is our clients. They measure the positive impact of advertising mail by their business results.

We employ 4,000 associates nationwide and, through our contracts with vendors for everything from information technology and security to child care, we provide employment for thousands more. We maintain 23 production facilities and 50 sales offices nationwide, invest in equipment, purchase enormous quantities of paper, keep dozens of printers busy and provide a return to our shareholders. Two out of every three dollars we spend is for postage to send our clients' advertising messages to 65 million or more households each week with tens of millions more on a monthly basis.

ADVO is part of a huge mailing industry. The Mailing Industry Task Force has documented the facts that the mailing industry employs nearly 9 million people and generates $871 billion of economic activity each year.

Our business is good business for the Postal Service. Current law as implemented by the Postal Rate Commission ensures that each type of mail covers its own costs and contributes to overhead. Exceptions enacted by Congress require lower rates for nonprofits and other privileged mailers like the blind and libraries, but all commercial standard mailers not only pay their own way but also provide substantial overhead contribution. Claims that standard mail is being subsidized are false. Last week my written comments demonstrated that our mail is profitable for the Postal Service. We are not a burden on the mailstream but rather the source of current and future revenue growth which will maintain this important asset for our country and our economy. I trust that the Commission's recommendations will facilitate the growth of businesses like ours and the mailstream overall. I encourage recommendations that would foster competition and not protect competitors from honest competition for advertising dollars.

A market-focused Postal Service should be committed to universal service, to a competitive pricing strategy, and to modern business practices, particularly in the areas of payment and credit. Its culture should be transformed from an operationally-driven organization to one that is focused on serving its customers while enabling itself and its customers to grow by expanding services that grow top line revenue.

As the Commission debates "universal service," I know you will keep in mind that reaching every address every day is an extraordinary and highly competitive achievement. The Postal Service's network expands along with the country's population. It's an asset that distinguishes the Postal Service as a medium that keeps pace in real time with household and business growth. Universal service is the Postal Service's proud burden and competitive advantage: every American has a mailbox and looks at what's been put inside, and messages are delivered free to the recipient. Countless competitors try everyday to equal this incredible achievement; many view it as their key strategic need for future success.

As the Commission considers proposals on how postal rates should be set, it should recognize that what the Postal Service needs a pricing strategy designed to bring about growth. It should set prices with the aim of growing the business and maximizing revenue. Recent action by Congress and the President with regard to the Postal Service's pension liability has given mailers a brief opportunity for a few years of rate stability. The Postal Service should use this period to find more contract candidates like Capital One. The Commission should recommend that the Postal Service make pricing decisions that seek to grow revenues and profits based on *market* conditions. The ratemaking process should be overhauled to reduce uncertainty by forbidding rate increases that exceed the rate of inflation.

While its origins predate the birth of our nation, the Postal Service needs the business tools necessary to succeed in this century. The Postal Service still lacks flexible payment term programs. Unlike any competitive delivery service, the prepayment requirement inhibits the Postal Service's and our company's potential to grow by requiring us to pay in advance for the services we purchase to provide to our clients. The Commission should recommend that the

Postal Service provide creditworthy mailers a reasonable time for payment – say 30 days – as is the norm in most sectors of our economy.

To sum up, cost control is essential for all commercial enterprises in today's economy, but it does not alone assure success. Success requires responding to market demands. The Postal Service needs to respond to the market's need for competitive pricing and to foster those segments of the market that have the potential to grow. I would again call your attention to the materials I submitted last week with regard to costs, the variety in the mailstream, and the value of standard mail.

As a member of the Steering Committee of the Mailing Industry Task Force and an officer of the Mailing Industry CEO Council, I firmly believe that this industry has tremendous growth potential, growth that would cause our company, our clients, the overall economy, and the Postal Service to prosper. I urge this Commission to make recommendations that will bring that prosperity into reality.

I would be pleased to answer any questions.

Supplemental Material

The time allotted for oral remarks does not allow a detailed exploration of many issues. At the Commission's invitation, I address the following topics in more detail in attachments to my testimony.

Cost Containment

To succeed, the Postal Service must continue its ongoing efforts to control costs and improve productivity. In addition the following areas require particular attention by the Commission: Contract and Procurement Law, Operational and Facilities Constraints, Collective Bargaining, Fringe Benefits, Grievances, and Workers' Compensation.

The Market for Mail and Standardization

Automation and standardization are often attractive methods of reducing costs. However, the Commission should be wary of any proposals that would restrict the variety that is essential to growing the mailstream.

The Importance and Price Sensitivity of Enhanced Carrier Route (ECR) Mail

The Postal Service depends on the contribution from ECR mail to help cover its overhead. ECR mail is not subsidized by other classes of mail. To the contrary, ECR cost coverage is higher than that of First Class and higher than all other types of standard mail despite the fact that it is the most price-sensitive.

Next Steps Following Public Law 108-18

The Commission should recommend that the Congress enact legislation giving the Postal Service certainty and flexibility with regard to the savings realized due to the corrected contribution to the Civil Service Retirement pension fund.

Cost Containment

Continual cost containment and productivity improvements are essential hallmarks of successful businesses today. To succeed to today's competitive environment, the Postal Service will need to continue and expand the cost-containment efforts begun under the Transformation Plan. In addition, the Commission should recommend that the Congress and the President act to remove certain financial burdens from the Postal Service that exceed those borne by private businesses. Just as the Congress acted to correct the payments to the Civil Service Retirement System, issues such as retiree health care and worker's compensation must also be addressed.

The Postal Service committed to reducing costs by $5 billion over five years in its Transformation Plan issued in April 2002. To date, the Postal Service appears to be on target to achieve this goal. The efforts of the Postmaster General and others to control costs are to be applauded and these efforts should be encouraged and continued. In addition, the President's Commission to should recommend changes that will allow the Postal Service's executives and managers to further bring costs under control.

Contract and Procurement Law

The Postal Service is subject to a modified version of federal procurement law that imposes additional costs and constraints on the USPS compared to the private sector. They affect many aspects of general procurement, facilities construction, real estate leasing and purchasing, and transportation contracting. The USPS should be subject to purchasing and contracting statutes and obligations applicable to commercial organizations, (e.g., the uniform Commercial Code).

Operational and Facilities Constraints

The Postal Service is forbidden by law from closing post offices solely for economic reasons, has political difficulty closing larger postal facilities, and must obtain advisory opinions from the Postal Rate Commission for nationwide changes in service. Competitors to the Postal Service have full flexibility to change their network of facilities and services to efficiently match changes in their own business and customer needs. The USPS should also.

Collective Bargaining

Labor costs make up about 80% of USPS annual expenses. Employees have collective bargaining rights with binding arbitration. No other federal employees have the right to wage arbitration. The current system drives the parties to take extreme positions during collective bargaining and arbitration, there is no statutory guidance concerning the protection of USPS financial viability or mail market interests, and the process is extremely time-consuming and adversarial. Further, the process has embedded work rules that seriously reduce management flexibility and operational efficiencies.

At a minimum, the arbitration process should be changed to the “last, best, and final offer.” The law should be changed to require the arbitrator to consider the financial viability of the USPS and the impact on mailers of any decision. Additionally there should be procedural changes to include mandatory mediation and fact-finding to work with both parties to negotiate a settlement -- with arbitration occurring only if such negotiations fail.

Finally, certain management constraints should be removed from labor negotiations in order to reduce the number of inefficient work rules. Successful commercial enterprises need to have flexibility with regard to the use of temporary and part-time employees, transfers of employees, cross training to help employees develop skills to perform different tasks, and, when appropriate, to contract out.

Federal Benefits

All postal workers are statutorily entitled to federal retirement pension and health benefit programs which are not subject to negotiation. Over the past 20 years, these postal fringe benefits have risen 27% more than those in the private sector since private sector benefits have been modified to reflect changed economic conditions. To control these costs, all benefits as well as wages should be subject to contract negotiations and arbitration; the statute should require benefits not greater than those offered in the private sector.

Grievance Procedures

The grievance mechanisms developed under the Postal Reorganization Act have been unsuccessful. Of particular concern is the dual grievance process available to postal employees. According to the Postal Service's own Transformation Plan, "The USPS currently has overlapping and duplicative processes for employees to file complaints concerning workplace disputes. This generates excessive administrative expense associated with managing these processes." In many circumstances, Postal employees may actually pursue a single complaint under more than one grievance procedure.

The dual complaint system should be eliminated. Further, the grievance-arbitration process should be reformed by establishing both management and labor incentives to avoid grievances, improving labor-management problem solving and mediation, and permitting action against both chronic grievers and managers that generate excessive grievances, including dismissal.

Workers' Compensation

The law governing workers' compensation for postal employees severely restrains the USPS from managing escalating compensation and health costs compared to private sector workers' compensation laws. These restraints include:

- Inability to contact medical provider by phone
- Lack of waiting period before wage-loss compensation is paid
- Overly generous compensation rates and benefit periods
- Inability to control medical costs
- Limitations on formal challenges to claims
- Inability to use any workers' compensation administration other than Office of Personnel Management.

The private sector and many state governments have adopted innovative reforms in the past few years to control workers compensation costs, but the Postal Service has not benefited from these reforms. Federal law allows employees a substantially longer period of time within which to file workers' compensation claims than do most state laws. This increased time period enlarges opportunities for fraudulent claims. Under the federal program, workers compensation recipients receive COLA increases, which they do not do in most states. Further, the Federal government manages the workers compensation program and charges the Postal Service not only the costs of claims to injured employees but also a $30 million administrative fee. To control these medical and compensation claims and administrative costs, the USPS should be permitted to use private sector programs, under private sector law, to manage its workers' compensation claims

The Market for Mail and Standardization

Standardization has been proposed as a means of cutting costs. While cost reductions and efficiency are laudable goals, standardization cannot be looked at in a vacuum. The market must also be studied to ensure optimum bottom-line results for the Postal Service and its customers. It is also important to distinguish between operational standardization, i.e., establishing uniform processes and procedures, and product standardization, which, if taken too far, will undermine the Postal Service's efforts to grow volume and revenue.

Operational Standardization

Standardization of operational processes is a laudable goal that can lead to cost reduction. To the extent that standardization leads to lower costs, lower postal rates, and equal or better service, it is obviously beneficial to customers.

However, operational standardization if pursued as an end in itself can be taken too far, to the detriment of the Postal Service's bottom line. If standardization squeezes out profitable products that, for marketing or other reasons, cannot fit the standardized mold, or leads to excessive non-standard rate surcharges for price-sensitive products that otherwise provide a positive contribution to overhead, the Postal Service may end up losing valuable market segments.

Product Standardization

Standardization of products is more troublesome, especially if it is undertaken without consideration of the market and pricing needs of customers. Forcing customers to modify their products to fit a standardized mold can lead to the loss of profitable business.

ADVO faces these same "standardization" issues in our business. Both ADVO and the Postal Service provide multi-product services to a wide range of customers who have widely different service and market needs. We serve over 26,000 retailers and service businesses, large and small, with differing market needs and price sensitivities. Because of these differences, our customers use widely varied advertising pieces – ranging from small postcard and single-sheet ads to large multi-page tabloid flyers of varying sizes and paper qualities. Our production task, combining these many types of ad pieces into a single package going to households, would obviously be made simpler and less costly if we required rigid "standardization" of ads from customers.

But our customers have other choices besides the mail. If we attempted to impose rigid product standardization, we would lose profitable segments of business to our competitors. Standardization that ignored customer needs and the marketplace would actually be detrimental to our business.

The same would be true if we imposed surcharges on nonstandard pieces without regard to product price sensitivity. If a nonstandard product covers its costs at standard market-based rates and provides us a contribution to overhead, we are better off than if we imposed a surcharge that drove the product away.

In the end, our customers need three basic things from us: (1) an affordable and competitive price; (2) flexibility in format and preparation requirements; and (3) consistent and predictable service. These are the same things we and other postal customers need from the Postal Service. If we fail to meet any one of these customer needs – such as by imposing rigid standards or above-market rate surcharges -- we risk losing profitable business to our detriment. The same holds true for the Postal Service.

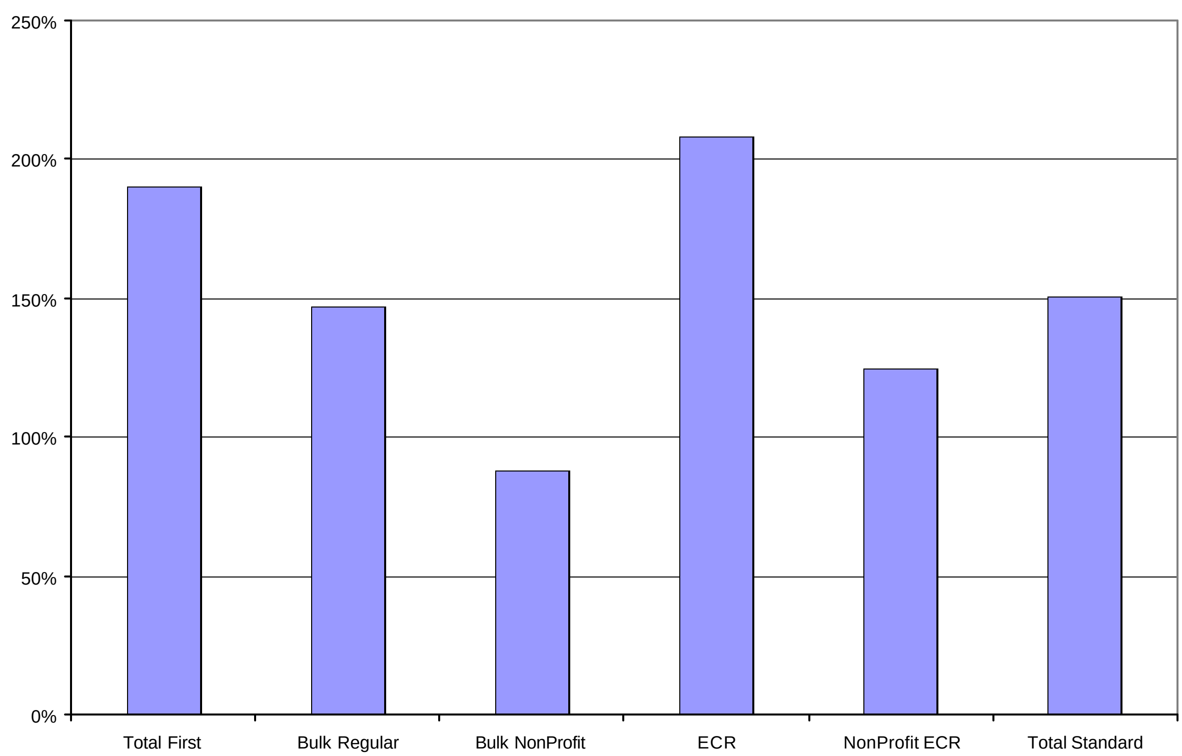
The Importance and Price Sensitivty of Enhanced Carrier Route (ECR) Mail

The business we bring to the Postal Service is essential to the Service's long term viability. While others have suggested that our mail is "subsidized" by the rates paid by other mailers, in fact we provide substantial contribution to the Postal Service's overhead. This contribution allows the Postal Service to provide affordable service to all Americans. However, because our mail is price-sensitive, rate increases have and will continue to drive our volume (and revenue) out of the Postal Service into other delivery methods and advertising media.

ECR Rates are not "Subsidized" by Other Mailers

Given the Postal Service's "breakeven" requirement, the Postal Rate Commission has ensured, as required by law, that all types of mail cover their own costs and contribute to the

Comparison of Cost Coverages



Source: Postal Rate Commission, Docket 2001-1

Postal Service's overhead. (The exceptions are the interventions by Congress to lower the rates for nonprofit and other privileged mailers such as libraries.) All commercial mailers are required to pay their own way and make a contribution. ECR mail makes the highest percentage contribution to institutional costs of any subclass in the postal system. The current cost coverage for ECR mail (revenue divided by cost), including both commercial and subsidized nonprofit mail is 201 percent. Thus, the true cost coverage for commercial ECR mail alone is well above 200 percent, representing a pricing markup of more than 100 percent above costs which is higher than First Class and higher than all other standard mail subclasses.

The Competitive Marketplace

ECR mail has the highest cost coverage despite the fact that this type of mail is the most price-sensitive, with an elasticity more than twice as large as first class mail according to George S. Tolley, Ph.D., Professor emeritus of economics at the University of Chicago, the Postal Service's witness in the R2001-1 Rate Case.

The Postal Rate Commission has long recognized the high price sensitivity of ECR saturation mail. This price sensitivity is due to a number of factors. For saturation mail businesses, postage represents a much higher proportion of total costs (typically 25-50%) than for other businesses using the mail. They also incur a considerable amount of worksharing expense so that there is little work left for the Postal Service to do other than deliver the mail.

> "Carrier route presort mail contains a great deal of saturation mail, where mail costs are a higher proportion of the costs of doing business, suggesting greater sensitivity to the mail price than in non-carrier-route presort mail...." PRC Rec. Decision, Docket MC95-1, at V-188.

In addition, saturation mailers face vigorous competition for distribution of preprint advertising from non-postal distributors such as newspapers and private delivery companies. Finally, saturation mailers can and do shift from mail to private delivery, using either their own private delivery network, an independent distributor, or joint ventures with newspapers. For these reasons, as PRC has acknowledged, saturation mail is the most price sensitive component of the ECR subclass.

> "Carrier route mailers have higher own-price elasticities than noncarrier route mailers, *especially in the saturation categories*." PRC Rec. Decision, Docket MC95-1, at V-190 (emphasis added).

The Postal Service as well has documented that ECR mail, in the aggregate, has a price elasticity more than twice as high as First Class mail.

Mail Category	Price Elasticity
First Class – Single Piece	-0.311
First Class – Bulk	-0.071
Enhanced Carrier Route	-0.770

Source: USPS Witness Tolley, Docket R2001-1, USPS-T-7.

For saturation mail, the most price-sensitive component of ECR, the disparity is much greater. A pricing scheme which would impose a higher per-piece unit contribution on ECR mail (and a far greater than 200 percent cost coverage), would simply drive saturation advertising out of the mail.

No business can remain viable if it ignores market and demand factors when setting prices. Higher rates for ECR mail will drive volume and revenue out of the Postal Service, and the Postal Service will lose the significant contribution made by ECR mail. If growth of other types of mail remains weak, the Postal Service will become increasingly dependent on the volume, revenue, and contribution that ECR can deliver. Although recent weakness in the overall economy and the advertising industry has suppressed advertising volume growth, if the right choices are made by the Commission and the Congress, volume growth can resume and even accelerate, bringing needed revenue and contribution to the Postal Service to offset what is likely to remain anemic (at best) growth in First Class volumes.

Next Steps Following Public Law 108-18

The recent enactment of the Postal Civil Service Retirement System Funding Reform Act of 2003, Public Law 108-18, is an important milestone toward improving the Postal Service's financial position. The law identifies the Postal Service's current over-funding of its Civil Service Retirement System pension fund, and quantifies the annual "savings" that should accrue to it to offset the over-funding. By its terms, however, the law provides only a temporary three-year fix through FY 2005, and contemplates a further review by Congress next year aimed at enacting a permanent fix.[1]

Under this review procedure, the Postal Service must submit a plan to Congress by September 30 of this year, specifying how it intends to use post-2005 savings, estimated at several billion dollars annually over the next 20-30 years. The Postal Service is directed to consider whether and to what extent those future savings should be used to address (1) debt repayment, (2) prefunding of postretirement healthcare benefits, (3) productivity and cost saving capital investments, (4) delaying or moderating increases in postal rates, and (5) any other matter. In addition, the Postal Service is specifically directed to consider "the work of the President's Commission on the United States Postal Service."

The two most critical elements of any permanent fix to the pension over-funding are (1) the need for certainty that the annual savings will be made available to the Postal Service, and (2) the need for substantial flexibility over the use of the savings.

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[1] For fiscal years 2003-2005, the law allows the Postal Service to utilize the annual savings but specifies that the savings be used only to reduce USPS debt and to forestall the next general rate increase until 2006. For years beyond FY2005, the law provides less certainty as to the availability and use of the annual savings by the Postal Service. The post-2005 annual savings will be placed in escrow and cannot be used by the Postal Service until and unless Congress acts.

Certainty that these post-2005 savings will be available is essential not only to shore up the Postal Service's financial condition, but to enable it to engage in meaningful short- and long-range planning.

Flexibility over use of the savings is important so that the Postal Service can respond to changing circumstances over the next twenty or more years. At this time, no one can predict with any certainty what the Postal Service's most pressing financial needs will be five or ten years from now, much less twenty years hence. Its longer term needs will depend on a number of factors largely beyond its control, such as the state of the American economy; the dynamics of the competitive marketplace, including both electronic and hard copy alternatives to the mail; and wage and cost inflation. Capital investment needs may, and likely will, change over the longer term. Likewise, the need to mitigate rate increases will likely fluctuate over time, depending on then-prevailing economic and competitive conditions. Rigid up-front restrictions on use of these future savings would hamstring the Postal Service's ability to manage and to adapt to change.

Decisions on specific uses for these savings are, of course, a matter for Congress. The Presidential Commission, however, should emphasize the general need for the Postal Service to have reasonable certainty and flexibility with respect to these savings.

ADVO, Inc.
OVERVIEW

ADVO, Inc. (NYSE: AD) is the largest full-service targeted direct mail marketing services company in the United States, with annual revenues of over $1.1 billion. The Company's shared mail advertising programs reach 102 million U.S. households on a weekly and monthly basis. This includes its core ShopWise™ branded programs, and the reach of its ADVO National Network Extension (A.N.N.E.) program. Additionally, the Company's SuperCoups® advertising solutions provide targeted advertising for local neighborhood businesses. ADVO launched the America's Looking For Its Missing Children® program in partnership with the National Center for Missing & Exploited Children and the United States Postal Service in 1985, and ADVO's missing child cards are responsible for safely recovering 126 children. ADVO has 23 mail processing facilities and 50 sales offices nationwide. ADVO's corporate headquarters are located at One Univac Lane, Windsor, Connecticut 06095, and the Company can be visited at its Web site at www.advo.com.

Statistics:

Founded:	1929
# of Clients:	Over 26,000
Clients Include:	Retailers, manufacturers and service providers on the local, regional and national levels
Annual Mail Volume:	3.4 billion shared mail packages (containing over 26 billion advertising pieces)
# of Employees:	More than 4,000
# of Sites:	50 sales offices; 23 mail processing facilities
FY02 Revenues:	$1,130.1 million
Traded:	NYSE: AD
Headquarters:	Windsor, Connecticut
Chairman and CEO:	Gary Mulloy

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Gary M. Mulloy
Chairman & Chief Executive Officer

Gary M. Mulloy is Chairman and Chief Executive Officer of ADVO, Inc., the nation's largest targeted direct mail marketing company, headquartered in Windsor, Connecticut. The company's annual revenue is approximately $1 billion and its common stock is traded on the New York Stock Exchange. Mr. Mulloy became ADVO's Chief Executive Officer in January 1999 and assumed the Chairman role in June 1999.

Mr. Mulloy joined ADVO as President and Chief Operating Officer in November 1996, bringing to the company nearly twenty-five years of management experience, as well as sales and marketing expertise. In this capacity, Mr. Mulloy was instrumental in steering the company toward its strategic targeting vision. He also spearheaded efforts to re-margin ADVO's business and is credited with nearly doubling the company's profitability during his tenure.

Before joining ADVO, Mr. Mulloy served as President and Chief Executive Officer of Sunnyvale, California-based, contact lens manufacturer Pilkington Barnes-Hind, Inc. (1991-1996), a division of Pilkington Vision Care. During his tenure, Mr. Mulloy is credited with significantly increasing the company's revenues and profitability.

Mr. Mulloy was President and Chief Executive Officer of the Maybelline cosmetics company, previously a unit of Schering-Plough Corporation, until 1991. He also held a range of senior executive management and marketing positions at Schering-Plough and its Maybelline unit during his fifteen years with the firm. Earlier in his career, Mr. Mulloy held marketing and management positions with the Gillette Company and the Burger King Corporation.

Mr. Mulloy received his B.S. degree in Marketing from the University of Illinois.