MAIL DIVERSION

Mail volumes are under attack from a number of sources: technological diversion, the economy, competition, regulatory changes, business consolidation and other factors. This paper focuses primarily on the forecasted impact of technology on postal volumes and revenues, and the implications of that diversion for the Postal Service's ability to continue to provide universal service at affordable prices.

Background information is provided on the economic reality of the Postal Service's reliance on First-Class Mail® (FCM) and why that product line is at risk. Offsetting the loss of FCM volume and contribution with matching revenue from other hard copy mail products is not realistic. Cost cutting and adjustment of infrastructure will be required. At the same time, aggressive action to increase revenues is more important than ever. The good news is that hard-copy mail is still a powerful communication medium. With added product testing and pricing flexibility, the Postal Service can more successfully react to market and industry changes to capture essential revenues to maintain this universal service.

Mail Today

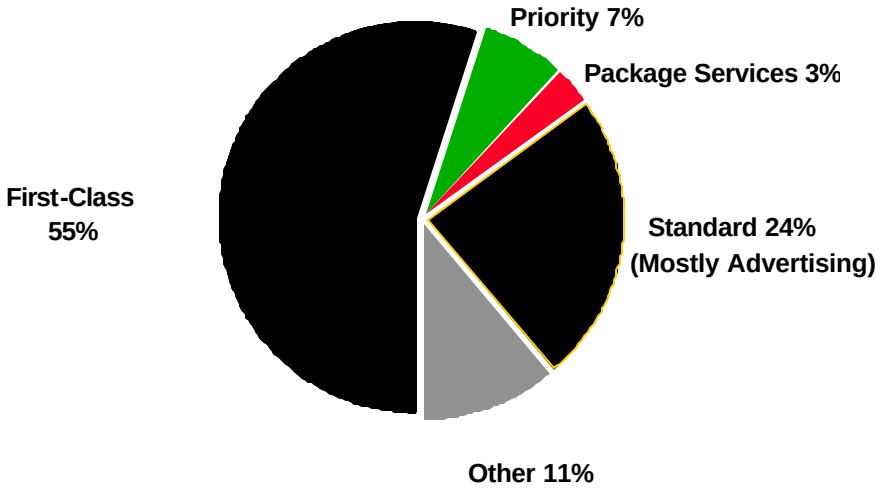
Since its inception, the Postal Service has traditionally been used to move messages, money, and merchandise. Over time the mail has grown into a sophisticated, complex industry which has become a critical component of the value chain that links businesses and consumers, and businesses to other businesses, as well as consumers to consumers. Recent years have been

influenced by the influx of competitive and technological forces which has produced viable alternatives to some types of mail. For instance, FCM today essentially competes with electronic bill payment, direct deposit, electronic funds transfer, electronic data interchange, e-mail, fax, and advertising alternatives. Standard Mail competes for the advertising dollar with newspapers, magazines, radio, television, cable, internet, and e-mail. Finally, the Postal Service's package products compete with United Parcel Service, FedEx, Airbourne, and DHL, just to name a few, in the highly competitive package industry.

Impacts of First-Class Mail® Diversion

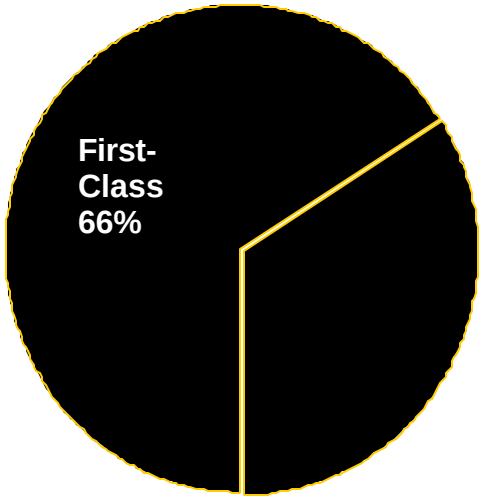
Of primary concern to the Postal Service is the diversion of First-Class Mail® (FCM). FCM represented more than 55 percent of total revenue in FY2002 (see Chart A). Bills, payments, and financial statements constitute approximately a quarter of U.S. mail volume and close to half of FCM revenues.

Chart A: Revenue Composition – FY 2002



The FCM volumes at risk supply a significant portion of the Postal Service's contribution to the fixed costs of the Postal Service's universal system (see Chart B). This portion of the mailstream has an above-average contribution margin and helps support the 38,000 Post Office facilities, the expansion of the universal delivery network, the fleet of more than 200,000 vehicles, as well as retirement costs and other overhead. FCM provides two-thirds of the total contribution of postal revenues toward fixed costs.

Chart B: Contribution to"Fixed" Costs – FY2001



To put in perspective the Postal Service's dependency on FCM it is best to consider what the impact would be if a portion of this volume leaves hard-copy mail. For instance, based on Fiscal Year 2001 data, a $1 billion loss in First Class single piece mail revenue equals approximately $424 million in contribution and about 2.4 billion pieces of mail representing 4.7 percent of the volume. This is a loss of that would create a significant financial burden on the organization. However, consider that there are approximately 37 billion financial statements, bills,

and payments mailed each year. A loss of 20 percent of this volume is approximately 7.5 billion pieces of mail (and 7.5 percent of total FCM volume) which provides a contribution of $1.3 billion toward the Postal Service's fixed costs. To recoup the lost $1.3 billion in contribution would require that one (or a combination of some or all) of the following scenarios occur in the Postal Service's other product lines:

- Standard Mail volume, used primarily for advertising, would need to increase by 21 billion pieces or 23 percent. This entails increasing direct mail as a percentage of total U.S. advertising from 19 percent to 24 percent. This is an unprecedented growth rate given that a one to two percent increase is considered substantial in this industry.
- Priority Mail volume would need to increase by 870 million pieces – a 79 percent increase. This would entail gaining about 33 percent of the total packages delivered in 2 or 3 days by our competitors.
- Express Mail volume would need to increase by 150 million pieces or more than 215 percent.
- Parcel Post would need to increase by 9.2 billion pieces or more than the size of the entire estimated package market.

The Technology Impact

Most recent data indicates that total FCM volume has declined over 2 percent in Fiscal Year 2003 representing a loss of more than a billion pieces of high-

contribution mail in less than half of the year. Thus far, through extensive cost-cutting initiatives, the Postal Service has been able to reduce expenses to lessen the impact of this revenue shortfall. However, this erosion of FCM is expected to continue as the Internet has accelerated the electronic diversion of key segments of the mail, including business correspondence, payments, and advertising. Internet applications threaten to reduce the use of mail for presenting bills and statements. Incremental diversion represented by Internet variables in the Postal Service's demand equations peaked at 3.8 billion pieces in FY2000. When the Internet bubble burst, incremental diversion slowed to 1.3 billion pieces in FY2002. Over the next several years it is projected that incremental diversion will return to a level of at least 2 billion pieces per year. The Postal Service acknowledges that projecting this rate of diversion is challenging, and involves as much art as science. There still remains a strong preference for hard-copy bills and statements by most people.

Prior to 1995, as the fundamental drivers of mail volume continued, such as increases in population, income, and education as well as the formation of new households and businesses, the net impact of electronic diversion on Postal Service volumes or revenues was relatively small. To the contrary, successive waves of new information technology and deregulation in the financial and telecommunication sectors had a positive impact on mail flows as new businesses marketed new services aggressively and created new accounts. The rapid computerization of business records at large firms in the 1970's and 1980's created

advantages to use the mail as a medium for delivering financial statements, bill presentments and bill payments. In the 1980's increased use of computer technology to create and target advertising mail had a positive impact on mail volume. At the same time, electronic data interchange (EDI) between mainframe computers allowed many labor intensive billing and payment transactions among large firms to be automated. While EDI reduced mail between large firms, the net effects of technology were generally positive since document creation and generation became easier, faster, and less expensive. But now electronic technology, with the nearly universal penetration and use of personal computers and the Internet among business and higher-income households, is negatively affecting three key uses of the mail: correspondence; statements, bills and payments; and advertising.

E-mail is the preeminent application of the Internet and it negatively affects hard-copy correspondence. E-mail has played a role in significantly reducing mail between businesses, including the exchange of legal documents, drafts, reports, orders, proposals, price quotations and other business correspondence. The business-to-business share of FCM declined between 1987 and 2001. In 1987, the business to business share of FCM was 37 percent. In 2001, this share dropped to only 26 percent representing an 8 percent drop in absolute volume. The sophistication of businesses and their willingness to adopt new technology enabled them to shift key processes to a more efficient electronic communication and transaction methods. E-mail's impact on correspondence between households is more limited, largely because inexpensive long

distance telephone rates and lifestyle changes had led to significant declines in personal correspondence long before the Internet entered households. Household-to-household mail volume fell from 25 percent of total FCM volume in 1968 to less than 8 percent today. Almost this entire decline had occurred by 1987, when household-to-household mail volume was 9 percent of total FCM volume. Nevertheless, personal invitations, college applications, resumes, etc., are increasingly being sent over the Internet.

Electronic bill payment has grown among households. Today one in two households pays at least one bill electronically. The proportion of all household bills paid electronically has risen from less than 3 percent in 1990 to more than 15 percent today. While traditional electronic methods (e.g.,automatic deduction, ATM, pay-by-phone) have grown, the Internet has accelerated the use of electronic household payments and has reduced mail volume. This trend will continue. Already, the mail's share of household bill payments has already fallen from 80 percent to 75 percent between 2000 to 2002.

Table A below splits American households into three groups: those who pay some bills online; those who pay some bills electronically, but none online; and the traditional households who pay no bills electronically. Online households pay only 44 percent of their bills by mail. In contrast, traditional households pay 90 percent of their bills by mail. Online bill payers are the smallest group (12 percent of all

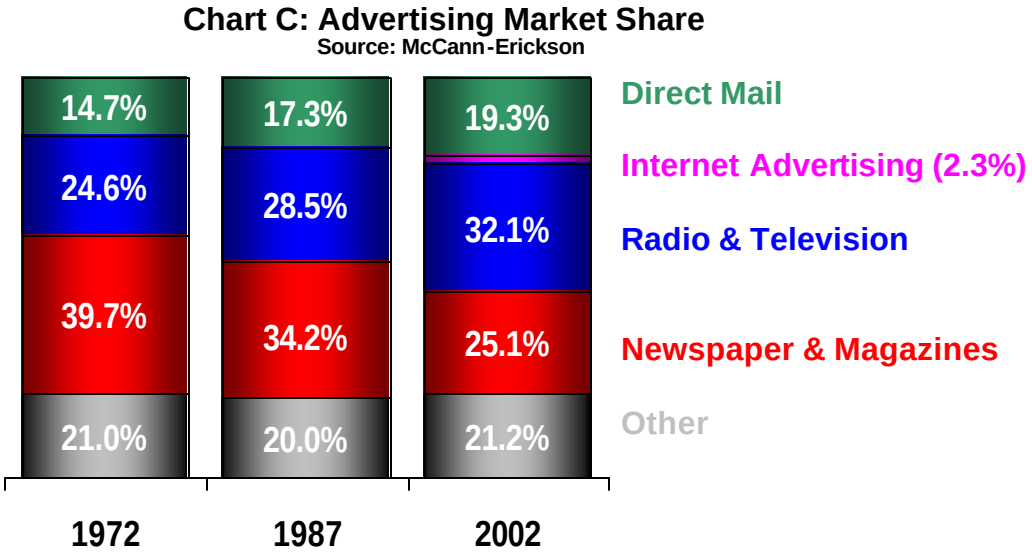
households) but will grow rapidly. Online bill payers have the largest number of monthly bill payments (13.9 bills per month).

Table A: Bill Payment Types

	On-Line Bill Payers	Other Electronic Households	Traditional Households
Mail Payment Share	**44%**	**70%**	**90%**
Household Share	**12%**	**38%**	**50%**
Monthly Bills Paid	**13.9**	**12.6**	**10.7**

Source: Household Diary Study, FY 2002

Advertising on the Internet did not exist six years ago. Internet advertising has grown to two and a half percent of the advertising market in six years. After peaking during the Internet bubble, Internet advertising declined. Most market observers expect that Internet advertising's market share will grow again in the near future. Less certain is what other forms of advertising will suffer. Over the past 30 years (as seen in Chart C) direct mail has grown as a percentage of the overall advertising dollar spent. However, the future impact of internet advertising is not yet clear.



Opportunities for the Mail

Mail is a mature industry and although there are many trends surrounding technology enhancements, and changes in behavior that will negatively impact mail volume, opportunities grow to mail use and volume still exist. First and foremost, the Postal Service's ability to manage costs and provide rate stability is important to avoid diversion. Additionally, as recent studies by the Institute for the Future continue to show, people still value mail, particularly consumers when receiving messages from businesses. The value that mail brings is still considered very powerful and is the preferred form of communication by consumers who value mail pieces which are relevant to their lives and interests. Advertising designs increasingly favor the type of delivery vehicle that mail provides. The physical presence of mail provides evidence about an offering, commitment, or confirmation that can be shared and stored. Additionally, mail tends to be less intrusive in

marketing messages than a telephone call or and unsolicited e-mail, and also offers more discretion about when to read it – unlike television or radio advertisements.

While changes in technology are, on the one hand, a threat to mail volume and revenue, these same changes are enabling businesses and consumers to continue to find new ways to use mail to add value to their communications and relationships. The development and use of "intelligent mail" provides an example of how technology innovation can enhance the value of mail and promote the growth of mail products. In 2001, the Mailing Industry Task Force recommended the development of the "intelligent" mail piece in an effort to make every mail piece unique. Following the regulatory process and the Postal Rate Commission recommendation, in April 2002, the CONFIRM™ product was fully implemented by the Postal Service to enable customers to uniquely identify First-Class, Standard, and Periodical letters and flats. The addition of this product enhancement allows the mailing industry to compete by including data that "live" with the mail piece. By linking mail with complementary information channels, intelligent mail creates value for the consumer, the sender, and the processor.

Another example of technology creating opportunities is the impact of the Internet in promoting the growth of remote shopping of merchandise. The Postal Service believes there is an opportunity in the market to provide an economical and convenient merchandise return product which will, in turn, enhance the remote shopping experience and promote further package growth. Leveraging its

extensive delivery network, the Postal Service, has worked to develop this product and is eager to test it in the market place. Again, prior to testing this service the Postal Service is obligated to follow regulatory procedures which will prolong implementation.

Need For Flexibility

The ability of the Postal Service to help shape its own future, either through cost reduction, productivity improvement, new product development, or through partnerships with online businesses, will depend in large part on the regulatory structure in place in the future. The Internet is bringing significant changes to the way businesses operate and compete, and flexibility is needed to respond to these changes. This is especially true for product testing and pricing. Likewise, the mailing industry can continue to have a hand in shaping business and personal communications, not only through the products and services provided, but also through emphasizing and reminding customers of its strengths – the reliable, secure, private, and timely provision of information services in a form consumers prefer, and especially the joy provided by personal communications. What happens with FCM volume trends will depend, in part, on how tastes change over time, and whether the mailing industry can do anything to affect tastes. Even with this effort, the Postal Service is likely to face significant challenges in the near future in determining how to respond to further electronic diversion while meeting its universal service obligations.