State of the Mail

April 27, 2012

Prepared by U.S. Postal Service Office of Inspector General
Risk Analysis Research Center
Report Number: RARC-WP-12-010

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Executive Summary

Mail binds the nation together. Mail disseminates educational, cultural, scientific, and informational content. Mail moves goods and services and is a key element in the flow of financial payments. Mail powers an economic engine sustaining over a $1 trillion industry employing more than 8 million Americans. Mail has a historic and celebrated past. Mail delivery to every household has been a key facet of American life. Mail is important. Unfortunately the U.S. Postal Service is under an unprecedented state of financial stress caused by three major economic phenomena: the Great Diversion, the Great Recession, and the lethargic economic recovery known as the Great Slump. This State of the Mail paper is a strategic assessment of the mail today. To this end, it assesses the outlook in different mail markets and discusses these economic phenomena.

Our strategic assessment finds that a dichotomy of prospects exists for most postal market segments. Despite the major strategic challenges facing the Postal Service today, a core set of business segments have encouraging prospects for prosperous growth. Direct mail advertising [in First-Class Mail (FCM) and Standard Mail (STD)] and two-and three-day package services exploit strategically important core competencies of the Postal Service, while benefiting from growth in eCommerce. These segments account for slightly more than half of mail volume, 37 percent of revenue and one-third of the contribution to institutional costs.

Mail Segments (FY 2010 millions)	**Outlook Level**							
	Promising			Neutral		Challenged		
	FCM Advertising	STD Advertising	Two- and Three-Day Packages	Overnight Flats & Packages	Ground Packages	FCM Correspondence	FCM Transactions	Periodicals
Volume	89,141			1,383		57,773		
% Volume	*52%*			*1%*		*34%*		
Revenue	24,468			2,926		23,557		
% Revenue	*37%*			*4%*		*35%*		
Contribution	8,433			332		10,477		
% Contribution	*33%*			*1%*		*41%*		

Source: OIG Analysis. Excludes Other mail.

Percent Contribution Per Revenue Dollar	
FCM Advertising	66%
FCM Transactions	52%
Overnight Flats & Packages	40%
FCM Correspondence	39%
STD Advertising	34%
Two- and Three-Day Packages	21%
Ground Packages	-18%
Periodicals	-33%

Source: OIG Analysis

In contrast to these promising business segments, three postal business segments face strong headwinds. Although correspondence and transactions mail and Periodicals are valued by postal customers, they are losing ground to formidable challenges in the marketplace. Electronic diversion and long-term secular downward trends continue to eat away at these segments which account for 34 percent of total volume, 35 percent of total revenue, and 41 percent of total contribution. This challenging environment does not mean that this mail is not valued by consumers or that it will necessarily disappear entirely, but rather that managing its decline will require increased management attention. The best solution may be a fundamental shift in business strategy, such as changes to pricing policy, adding new service offerings, or expanding into digital postal alternatives.

The paper continues with a discussion of a movement in corporate culture away from increasing market share and volume toward one of meeting customer needs in a financially sustainable way. The Postal Service could identify, manage, and market separate mail products with unique cost, contribution, and market characteristics. For example, transactions and correspondence, which are losing volume to digital substitutes, offer the second and fourth highest contribution margins, respectively. It will be a challenge to reenergize and offset losses from these mail segments. Managing in a financially sustainable way requires leveraging product strengths, identifying and exploiting new business opportunities, and at the same time, mitigating the adverse impact of technological change and secular downward trends.

Key Findings

We have assessed the state of the mail and offer ten key findings.

1. A strong, rapid mail volume recovery is not likely. Policy makers should not count on the Postal Service to grow its way out of its current problems.

2. A change in public policy and corporate culture that emphasizes contribution (the amount of revenue over and above the cost) over other concerns, such as volume growth, is crucial.

3. Today’s declining volume and shifting mail mix generate less contribution and are more sensitive to business cycle fluctuations than in years past. Public and management policy changes must factor this into account.

4. Declines in contribution per delivery point were traditionally modest until 2006. The steep decline that followed in product contribution per delivery point is unprecedented, but may represent the new reality, one that requires new solutions to align cost and revenue.

5. Remedies for the decline in contribution per delivery point are limited. To date, cost reduction measures, price decreases to stimulate sales, promotions to spur growth in existing products, and the introduction of new products have been inadequate to address the decline.

6. Price increases remain an option. The growth of the Internet as a competing technology adds complexity to this policy choice. A careful analysis of the Internet’s effect on the demand for mail indicates that volume is shifting to the Internet because it is a cost effective substitute, but the pace of diversion does not appear to be sensitive to postal price changes.

7. Historically, price increases have added to Postal Service net revenue. A series of moderate and predictable price increases, to the extent that market conditions allow them, would likely increase the revenue to the Postal Service, and could reduce or eliminate losses from products that are not currently covering costs.

8. The Postal Service is becoming increasingly dependent on advertising. Direct mail advertising is more sensitive to business cycle fluctuations. Therefore, greater resource flexibility will be needed in the future.

9. Increased dependency on direct mail advertising also weakens the imperative of the Universal Service requirement. Additional hard-copy and digital products and services that diversify the Postal Service's mail mix, beyond advertising, and that bind the nation together, are needed to secure the role of the Postal Service as a vital, national infrastructure.

10. Care must be taken that price increases do not further reduce the richness of the mail mix, especially with regard to mail that is highly desirable to recipients, and that is strongly connected to the Postal Service mission of "binding the nation together."

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Introduction

People spend time engaged with the mail to share opinions, make decisions about new products, manage their households, donate to their favorite charities, and manage their finances. These mail moments[1] remain valuable to senders and recipients alike. This State of the Mail paper is a strategic assessment of the mail today. To this end, it examines descriptive statistics and assesses prospects for each mail market. It then discusses selected trends that are affecting the mail. These are the three economic phenomena which we call the Great Diversion, the Great Recession, and the Great Slump. The paper continues with a discussion about the need for a change in corporate culture to one of managing for financial sustainability.

The Mail Today

Table 1 presents eight mail segments[2] based on six mail products[3] that customers use in five mail markets.[4] These eight mail segments account for the majority of the mail today. Table 1 also includes the estimated fiscal year (FY) 2010 volume, revenue, and contribution[5] for each mail segment.

In FY 2010, First-Class Mail (FCM) and Standard Mail (STD) were the two largest mail products accounting for over 94 percent of volume. First-Class Mail operates in 4 of the 5 mail markets, that is, correspondence, transactions, advertising, and packages. The domestic First-Class Mail sent and received by households in these mail markets accounted for 33 percent of total mail volume, 37 percent of total revenue, and 46 percent of total contribution.[6] The Standard Mail received by households in the advertising and packages mail markets accounted for 48 percent of total mail volume, 26 percent of total revenue, and 21 percent of total contribution.[7] Although Standard accounted for the majority of volume, First-Class Mail added more contribution to the Postal Service's bottom line.

Although Standard Mail accounted for the majority of volume, First-Class Mail added more contribution to the Postal Service's bottom line.

[1] The mail moment is the unique time when consumers bring mail into their home, sort, review, and act on it.
[2] The eight mail segments are First-Class Correspondence, First-Class Transactions, First-Class Advertising, Standard Mail Advertising, Periodicals, Two- & Three-Day Packages, Overnight Flats and Packages, and Ground Packages. Appendix A contains the definitions of the mail segments, including per unit contribution and contribution per revenue dollar by segment.
[3] These are official Postal Service classifications of First-Class Mail, Priority Mail, Express Mail, Periodicals, Standard Mail, and Package Services.
[4] The five mail markets are correspondence, transactions, advertising, periodicals, and packages.
[5] Contribution is product revenue minus costs attributed to a product. The Postal Service could lose money in total and still have positive product contribution.
[6] These sums include only the portion of Two- & Three-Day packages that are First-Class Mail.
[7] These sums include only the portion of Ground packages that are Standard Mail.

Advertising was the largest mail market and included First-Class Mail and Standard. Advertising accounted for 52 percent of total volume, 31 percent of total revenue, and 28 percent of total contribution. In contrast, the Packages mail market was smaller and included First-Class Mail, Priority Mail, Express Mail (flats and packages), Standard, and Package Services. Packages accounted for 1 percent of total mail volume, 14 percent of total revenue, and 7 percent of total contribution.

Table 1: The Mail Today – FY 2010 Data by Mail Segment (millions)[8]

Five Mail Markets	Eight Mail Segments	Six Mail Products: First-Class Mail	Priority Mail	Express Mail	Periodicals	Standard Mail	Package Services
Correspondence	**Correspondence**	Volume: 14,583 Revenue: $6,506 Contribution: $2,539					
Transactions	**Transactions**	Volume: 35,921 Revenue: $15,172 Contribution: $7,938					
Advertising	**Advertising**	Volume: 6,200 Revenue: $2,143 Contribution: $1,419				Volume: 81,841 Revenue: $16,651 Contribution: $5,612	
Periodicals	**Periodicals**				Volume: 7,269 Revenue: $1,879 Contribution: ($611)		
Packages	**Packages**	**One-Three Day** Volume: 1,099 Revenue: $5,675 Contribution: $1,402		**Overnight** Volume: 43 Revenue: $828 Contribution: $332		**Ground** Volume: 1,341 Revenue: $2,098 Contribution: ($368)	

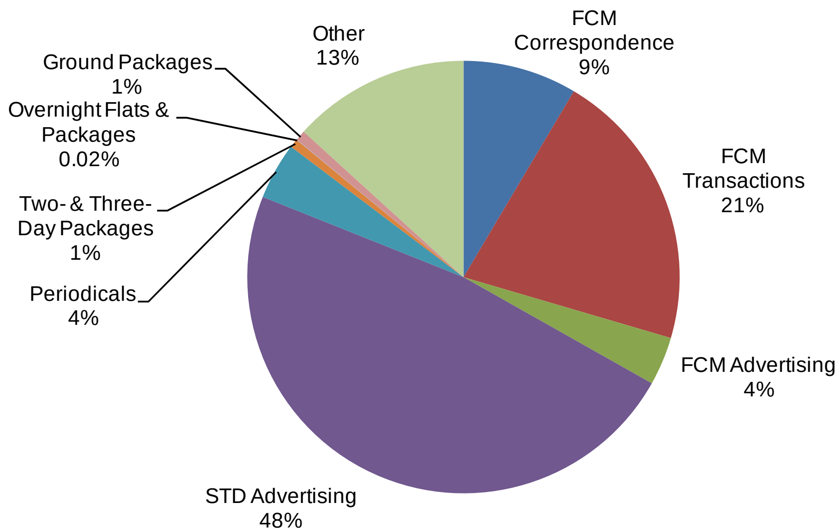
Mail Segments are the intersections of Mail Products and Mail Markets

Source: OIG Analysis

[8] In addition to the mail out of scope (e.g., International Mail), these data exclude nonhousehold-to-nonhousehold First-Class Mail.

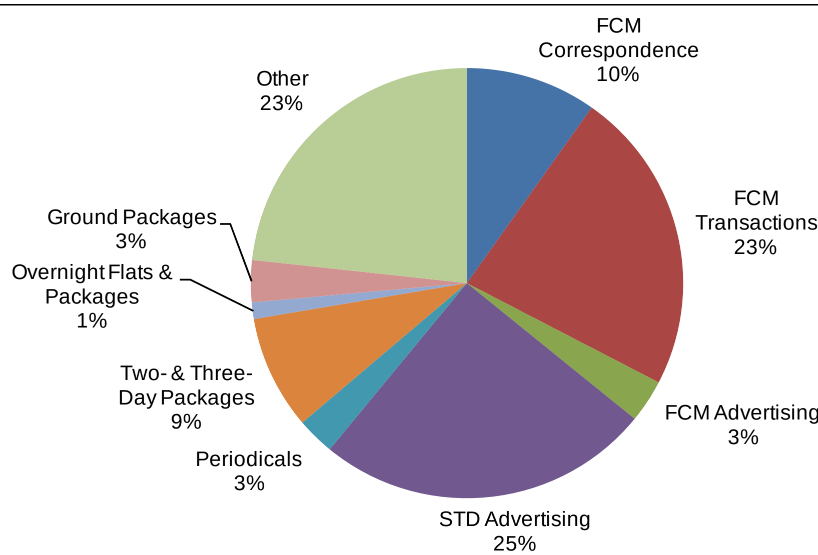
Figure 1, Figure 2, and Figure 3 present additional descriptive statistics on volume, revenue, and contribution for each mail segment. These figures show that Standard advertising generates the highest volume and revenue, but is second to First-Class Mail transactions in contribution.

Figure 1: The Mail Today – FY 2010 Volume by Mail Segment (171 billion)[9]



Source: OIG Analysis

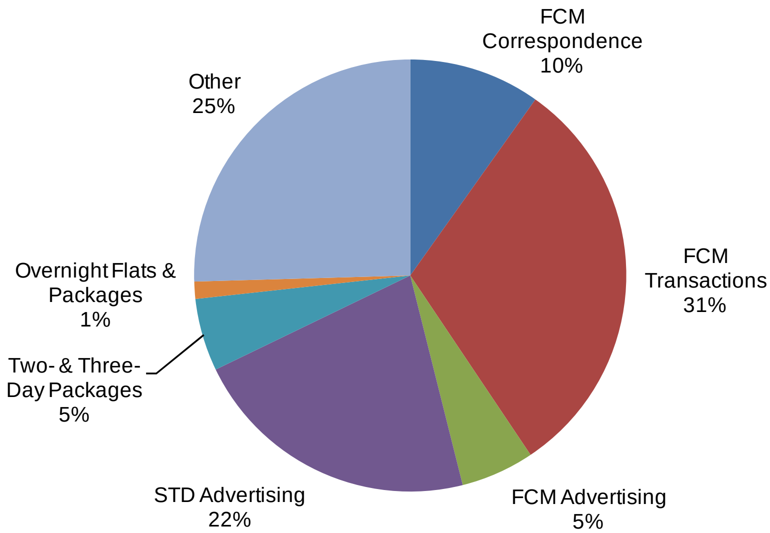
Figure 2: The Mail Today – FY 2010 Revenue by Mail Segment ($66 billion)[10]



Source: OIG Analysis

[9] These volumes are estimated based on the Postal Service's Revenue, Pieces and Weight (RPW) reports, the Household Diary Study (HDS), and the Cost and Revenue Analysis (CRA) reports. The "Other" estimate includes nonhousehold-to-nonhousehold First-Class Mail, U.S. Postal Service mail, free mail for the blind and handicapped, and International Mail. Segments do not total to 100 percent due to rounding.
[10] These revenues are estimated based on the HDS, RPW, and CRA. The "Other" estimate is the catch all category that includes nonhousehold-to-nonhousehold First-Class Mail, International Mail, special services, and miscellaneous (e.g., other, fees, fines).

Figure 3: The Mail Today – FY 2010 Contribution by Mail Segment ($25 billion)[11]



Source: OIG Analysis

Different mail segments have different strengths and weaknesses, and face wide ranging opportunities and challenges. Strengths and opportunities include the unique characteristics of emotional content mail, high response rates, complementary effects with other media, high value of content, competitive prices, first and last mile competitive advantages, and value-added services. Some mail market segments face headwinds from electronic diversion, negative economic trends, strong competition, and the lack of value-added services. Some mail segments have strong fundamentals while others face adversity. We computed overall assessments for each mail segment. The criteria we used, as well as our analysis per mail segment, can be found in Appendix B. There is a dichotomy of results in our assessment. Many mail segments have prospects for a bright future, other segments face formidable challenges. Only two segments are given a neutral outlook.

There is little middle ground and most of the mail faces either a promising or challenging outlook.

Table 2 presents the overall assessment and shows that three mail segments First-Class and Standard Advertising and Two- and Three-Day Packages have a promising outlook. Two segments, Overnight Packages and Ground Packages, are given a neutral assessment. Three segments are characterized as facing serious challenges, First-Class Correspondence and Transactions, and Periodicals.

[11] Contribution is estimated based on the RPW, HDS, and CRA. The total contribution of $25 billion accounts for mail segments with negative contribution. However, the pie chart excludes Periodicals and Ground Packages because they have negative contribution and presents a relative share of mail segments with positive contribution. The "Other" estimate is the catch-all category and includes nonhousehold-to-nonhousehold First-Class Mail, International Mail, and special services. Segments do not total to 100 percent due to rounding.

Table 2: The Mail Tomorrow – Mail Segments

Five Mail Markets	**Eight Mail Segments**	**Six Mail Products:** First-Class Mail	Priority Mail	Express Mail	Periodicals	Standard Mail	Package Services
	Correspondence	Challenged Threat: High Lack of Counter-measures: High Impact: Medium					
	Transactions	Challenged Threat: High Lack of Counter-measures: High Impact: High					
	Advertising	Promising Threat: Medium Lack of Counter-measures: Low Impact: Medium				Promising Threat: Medium Lack of Counter-measures: Low Impact: High	
	Periodicals				Challenged Threat: High Lack of Counter-measures: High Impact: Medium		
	Packages	**Two- & Three-Day** Promising Threat: Low Lack of Countermeasures: Low Impact: Medium		**Overnight** Neutral Threat: Medium Lack of Counter-measures: Medium Impact: Low		**Ground** Neutral Threat: Medium Lack of Countermeasures: Low Impact: Medium	

Outlook Evaluation Factors
- **Threat** – Are there existing or emerging threats to the mail segment?
- **Lack of Countermeasures** – Can the Postal Service counter or avoid the threats?
- **Impact** – What are the potential financial impacts of these threats on the Postal Service? How likely are they to occur?

Overall Outlook Assessments
- Promising Outlook – Has strong fundamentals and faces opportunities. Future impacts are potentially positive. Management can leverage strengths to lead to positive future results.
- Neutral Outlook – Faces equal challenges and opportunities. Future impacts might be negative or positive. Active and smart management is key to counter threats and exploit opportunities.
- Challenged Outlook – Has fundamentals that are trending negative and faces major challenges and hurdles. Future impacts are likely profound and negative. The only solution may be a fundamental change in business strategy.

Source: OIG Analysis

Table 3 presents a summary of our assessments by outlook. The three products with a positive outlook account for slightly more than half the mail volume, 37 percent of the revenue and a third of the contribution to institutional costs. Although these products face challenges, the prospects for growth remain strong. These products have sound fundamental characteristics and compliment the growing digital marketplace. Two products have a neutral outlook. These package products may benefit from the growth in eCommerce but have struggled to make a contribution to institutional costs. They account for only one percent of volume and contribution and 4 percent of revenue. The remaining products face a difficult business environment, due in large part to electronic substitutes. These products account for 34 percent of mail volume, 35 percent of revenue and 41 percent of the contribution. Mail still has value to both senders and recipients. The fundamental business challenge facing the Postal Service is to make these products more viable or replace them with equally profitable products — both physical and digital — while managing their seemingly inevitable decline.

Table 3: Mail Segments by Outlook, FY 2010

Mail Segments (FY 2010 millions)	**Outlook Level**							
	Promising			Neutral		Challenged		
	FCM Advertising	STD Advertising	Two- and Three-Day Packages	Overnight Flats & Packages	Ground Packages	FCM Correspondence	FCM Transactions	Periodicals
Volume	89,141			1,383		57,773		
% Volume	*52%*			*1%*		*34%*		
Revenue	24,468			2,926		23,557		
% Revenue	*37%*			*4%*		*35%*		
Contribution	8,433			332		10,477		
% Contribution	*33%*			*1%*		*41%*		

Source: OIG Analysis. Excludes Other Mail.

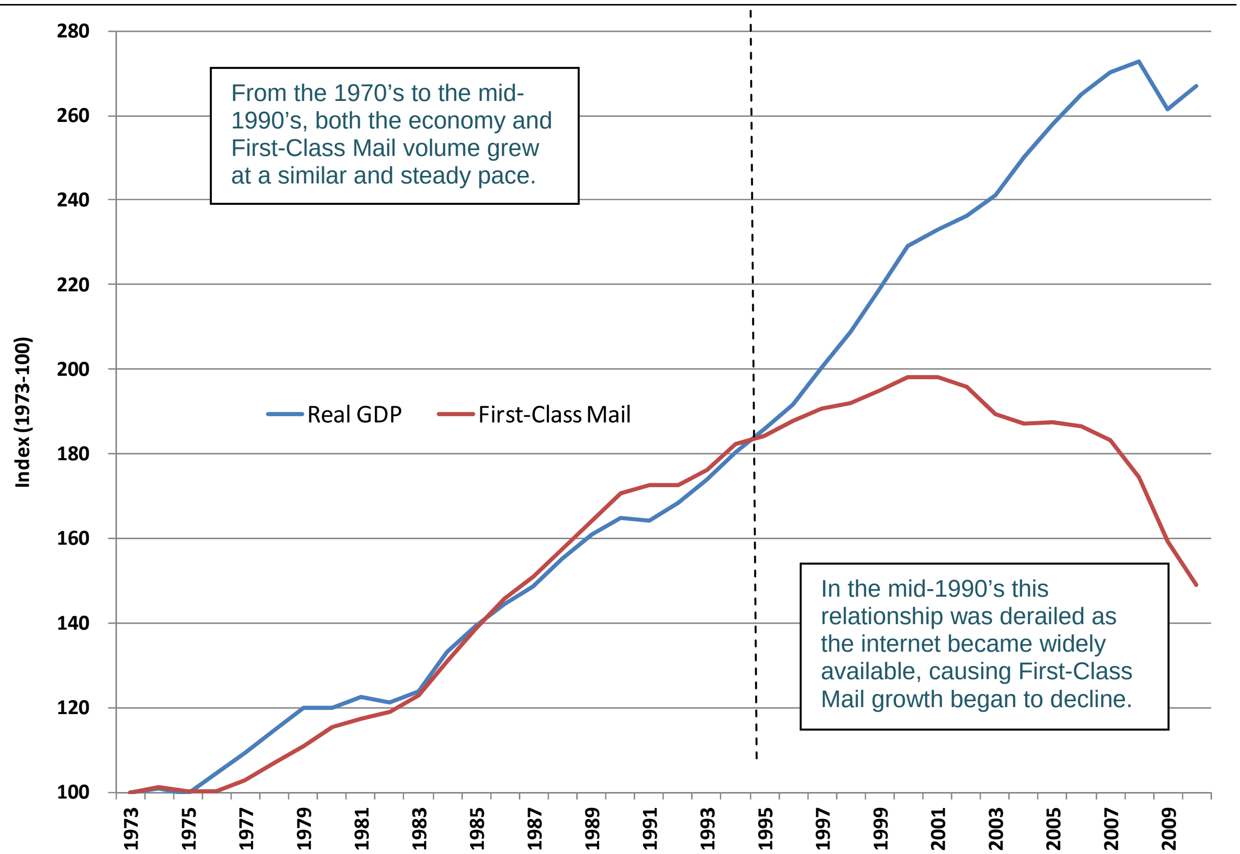
Three Major Trends

The Postal Service finds itself in the grip of three economic phenomena: the Great Diversion, the Great Recession, and the Great Slump. The Great Diversion is the long-term and relentless loss of the most profitable mail volume to electronic media. The Great Recession is the abrupt decline in the economy from December 2007 to June 2009. The Great Slump is the prolonged, lethargic recovery of the American (and, for that matter, global) economy. Any one of these phenomena would hamstring the Postal Service financially; taken together, they are crippling. This section of the paper explores how these three phenomena affect trends in Postal Service volume and contribution.

The Great Diversion

The Postal Service's financial dependence on First-Class Mail has been precarious for the last 16 years, as the expanded use of the Internet has made First-Class Mail less relevant to mailers. Figure 4 summarizes the diversion story succinctly.

Figure 4: Real Gross Domestic Product and First-Class Mail Volume (Indexed to 1973)



Sources: OIG Analysis and Peter Bernstein of RCF Economics and Financial Analysis

The economy, as measured by real Gross Domestic Product, grew at a steady pace through most of the last four decades. For the first half of this period, First-Class Mail volume grew at nearly the same pace as the economy. Then, in the mid 1990s, something clearly changed. Once the province of hobbyists and academics, the Internet became widely available to households and businesses. Slow dial up services gave way to high speed broadband connections.[12] Paid electronic billing services transformed into free bill pay service on every major bank's website. Although broadband penetration has slowed in recent years, there are many reasons to believe that access to and use of

[12] Ironically, much of the early growth of the Internet was fed by discs of America Online software distributed by mail.

the Internet will continue to grow. For example, mobile Internet access via smart phones continues to rapidly increase. Incremental expansion of broadband access to low income households continues to attract the attention of policy makers.

First-Class Mail volume growth slowed relative to the economy. The effect of electronic diversion was first felt by single-piece First Class Mail, but, in the early 2000s, it spread to bulk (i.e., workshared) First-Class Mail. At this point, First-Class Mail volume actually began to decline. But for a brief plateau in the mid-2000s it has shown no signs of positive growth.

The Postal Service would need 3.2 new pieces of Standard Mail to offset the lost contribution from a single piece of First-Class Mail.

The Great Diversion raised the grim prospect of replacing the Postal Service's most profitable product with something else. Obviously, the first candidate would be the second most profitable product, Standard Mail. Other than a small amount of light-weight parcels, Standard Mail is composed of advertising material. In 2010, Standard Mail earned about one-third the contribution of First-Class Mail. Put another way, the Postal Service would need 3.2 new pieces of Standard Mail to offset the lost contribution from a single piece of First-Class Mail. From 2008 to 2010, First-Class Mail volume declined by 13.4 billion pieces. To keep the Postal Service's contribution intact, Standard Mail volume would have had to grow by 43.2 billion pieces. History tells us that such a surge in Standard Mail volume would have been unprecedented;[13] Standard Mail volume has never increased more than 8 billion pieces in a single year. In fact, rather than increasing from 2008 to 2010, Standard Mail volume *fell* by 16.6 billion pieces.

Other products are available to stanch the bleeding from electronic diversion, but none of these products, alone or taken as a group, are nearly big enough. Express Mail, Priority Mail, Parcel Select, and all international Shipping Services produced $2.4 billion in contribution in 2010. This is only one fourteenth the size of First-Class Mail's contribution. Finally, all other products account for only about 2 percent of the total contribution attributable to products in 2010. Many of these products are "under water"; that is, their costs exceed their revenues.

First-Class Mail

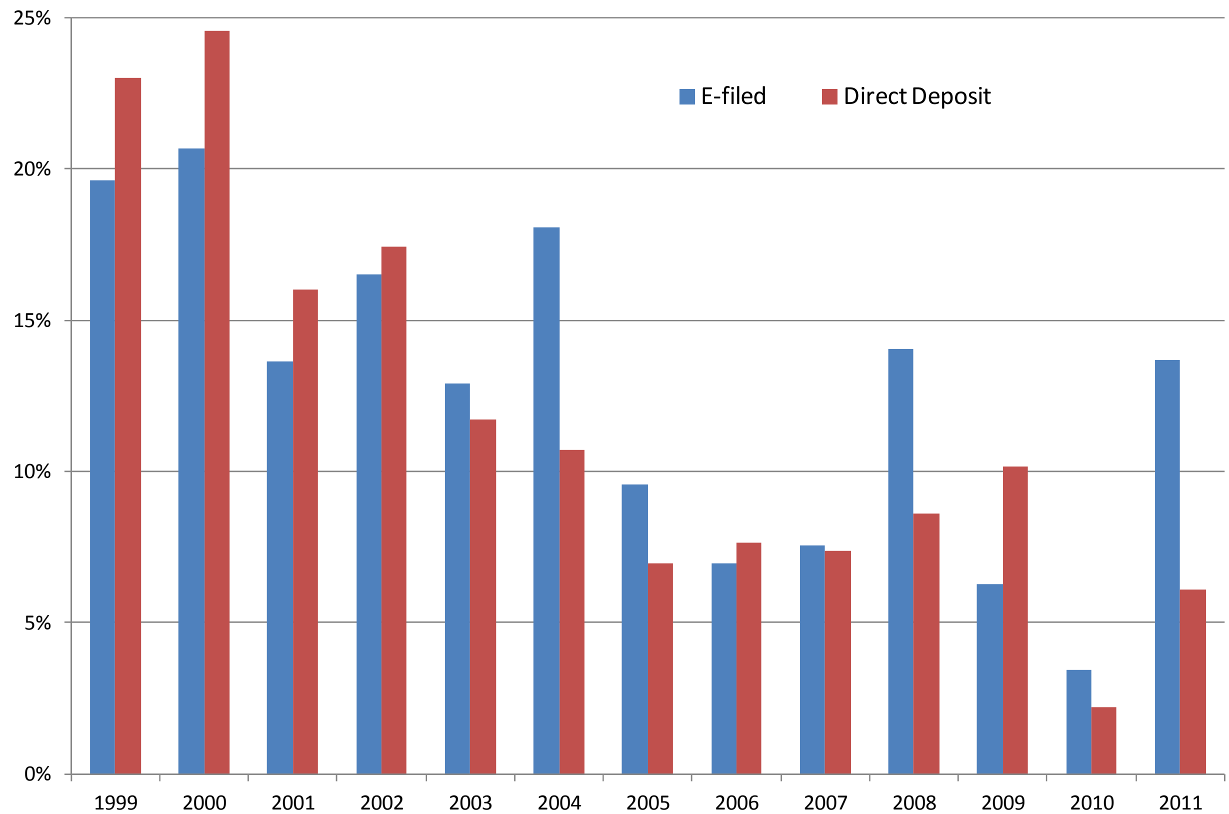
Personal Income Tax Returns and Refunds

It is reasonable to ask what the prospects are for an easing of electronic diversion. Personal income tax returns and refunds are perhaps one example of this, as evidenced in Figure 5. The Internal Revenue Service (IRS) has repeatedly failed to

[13] Aside from being unprecedented, a surge of volume of this magnitude could have two adverse consequences for the Postal Service. First, recipients of the surge in advertising mail might be annoyed by the sudden clutter in their mailboxes. This could result in a backlash from recipients characterized by low response rates, and renewed support for "Do Not Mail" legislation. Second, the surge could also cause recipients and policy makers to ask the question, "Why do we need a government agency to inundate us with all this advertising?"

meet its electronic filing goals.[14] One can view this as a result of a normal product maturation process. In the beginning, electronic adoption grew quickly. With each passing year, adoption growth slowed as reluctant hold outs continue to use the mail. In 2011, 77 percent of personal income tax returns were filed electronically.[15] Moreover, the IRS used direct deposit to provide 72 percent of all refunds.[16]

Figure 5: Annual Growth in Electronic Personal Income Tax Returns and Refunds



Source: IRS

Bills and Statements

Can the same observation be made for electronic bill payment? In 2010, household electronic bill payments exceeded household mailed payments for the first time. The average rate of growth in household bill payments since 2002 has been 14 percent; in 2010 it was 15 percent.[17] Unlike tax filings, the rate of growth of payments does not appear to be slowing noticeably.

[14] "IRS Will Not Meet 80% E-File Goal, Oversight Board Says," *Journal of Accountancy*, January 19, 2011, http://www.journalofaccountancy.com/Web/20113764.htm.
[15] OIG analysis based on IRS data found at http://www.irs.gov/newsroom/article/0,,id=220953,00.html.
[16] Ibid.
[17] OIG analysis of HDS data.

Bills and statements mailed in bulk from non-households to households, a very large segment of First-Class Mail, has yet to succumb to the onslaught of electronic diversion and remain overwhelmingly in the mail stream. The percentage of household bills and statements received electronically grew 82 percent, from 7.7 percent in 2007 to 14 percent in 2010. This diversion process is still in its early stages. Moreover, issuers of bills and statements, eager to convert their customers to electronic presentment, are meeting with unexpected resistance.[18]

The big gap between electronic bill payment and electronic bill and statement presentment can be explained by a number of factors. Households save money on postage, checks, and envelopes when they pay bills electronically. In contrast, unless they are actually charged for receiving bills and statements by mail, households accrue no direct savings from electronic presentment.[19] Moreover, mail affords certain other benefits to recipients of bill and statements. Mailed bills and statements can be filed away for record keeping. They also are a physical reminder that bills are due. Finally, electronic billing may make it inconvenient to switch banks (a plus for the bank but a potential minus for the consumer).

Correspondence

So far we have only discussed First-Class Mail that facilitates transactions. Another component of First-Class Mail that has been adversely affected by electronic media is correspondence. From 2002 to 2010, First-Class correspondence volume declined 18 percent, only slightly less than the 20 percent decline in transactions volume.[20] Of course, email is one reason for the decline. Another is the use of social media such as Facebook.

The historical, steady decline in correspondence mail will continue indefinitely.

These are new developments in a much longer story, however. The availability of direct-dial long distance telephone service, followed by telephone deregulation, and flat rate calling plans all resulted in substitution of voice communication for correspondence. Briefly, fax machines also competed with correspondence mail. In light of this long history of electronic diversion, it is safe to say that the steady decline in correspondence mail will continue indefinitely.

Netflix and Other Online Resources

Another development in this story it that of Netflix, which stood out as an example of how the digital age could benefit the Postal Service. Until recently, Netflix volume grew rapidly while most of First-Class Mail declined. It is now clear that streaming video,

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[18] Emmett Higdon, "Paperless Plight: Growing Resistance Outpaces Adoption Among US Bank Account Holders," *Forrester Research*, November 1, 2010, http://www.forrester.com/rb/Research/paperless_plight_growing_resistance_outpaces_adoption_among/q/id/57969/t/2 and "Why 82.639% of Internet Bankers will not turn off Paper Statements," EBilling News blog, May 6, 2010, http://ebillingnews.blogspot.com/2010/05/why-82639-of-internet-bankers-will-not.html.
[19] Of course, the higher cost of providing paper statements may be indirectly assessed in other charges related to the services, such as monthly service fees.
[20] OIG analysis of US Postal Service Household Diary Study 2003 and 2010.

whether by Netflix, Hulu, or other online resources, will replace more and more DVDs in the mail.

Rate of Electronic Diversion

The Postal Service has not released a detailed long-range volume forecast since March 2, 2010. Nevertheless, one can piece together a long-range outlook for electronic diversion of First-Class Mail from various published sources. The March 2010 forecast produced by Boston Consulting Group (BCG) predicted an increase in diversion of numerous segments of First-Class Mail over the next 10 years.[21] Also, according to the Postal Service's econometric model, the rate of electronic diversion, at least for transactions, increased during the recession.[22] Finally, recent postal testimony before the Postal Regulatory Commission is even more pessimistic than the BCG forecast.[23] It is safe to conclude that the Postal Service does not expect the rate of electronic diversion of First-Class Mail to abate in the long-term. This financial strain from increased electronic diversion is embedded in the Postal Service's long-range forecasts.

Informational Products

Other products are susceptible to electronic diversion, but many of these are losing money. Informational material such as periodicals, catalogues, music and books are all subject to electronic diversion. Periodicals mail has been subject to adverse trends for decades, a victim of the spread of broadcast television, cable television, the Internet and other entertaining diversions such as video games. Additional loss of Periodicals volume to electronic diversion exacerbates this long-term secular decline. According to Postal Service econometric estimates, Media and Library Mail lost about 11 percent of their volume to electronic diversion in 2008 and 2009.[24]

The recent explosion in the sales of tablet devices such as Amazon.com's Kindle Fire, Barnes and Noble's Nook, and Apple's iPad2 have added yet another chapter to the diversion story.

The recent explosion in the sales of tablet devices such as Amazon.com's Kindle Fire, Barnes and Noble's Nook, and Apple's iPad2 have added yet another chapter to the diversion story. Catalogues have lost their primacy in many retailers' advertising campaigns. Instead of catalogue after catalogue, mail order companies now send one catalogue, followed by oversized postcards and flyers to remind customers to visit the mailer's website.

Music has evolved from physical sales units such as long playing and single records to 8-track tapes, cassette tapes, and CDs, to digital sales units (MP3s). Music lovers now download their favorite songs to one or more digital devices. Mail order record clubs are

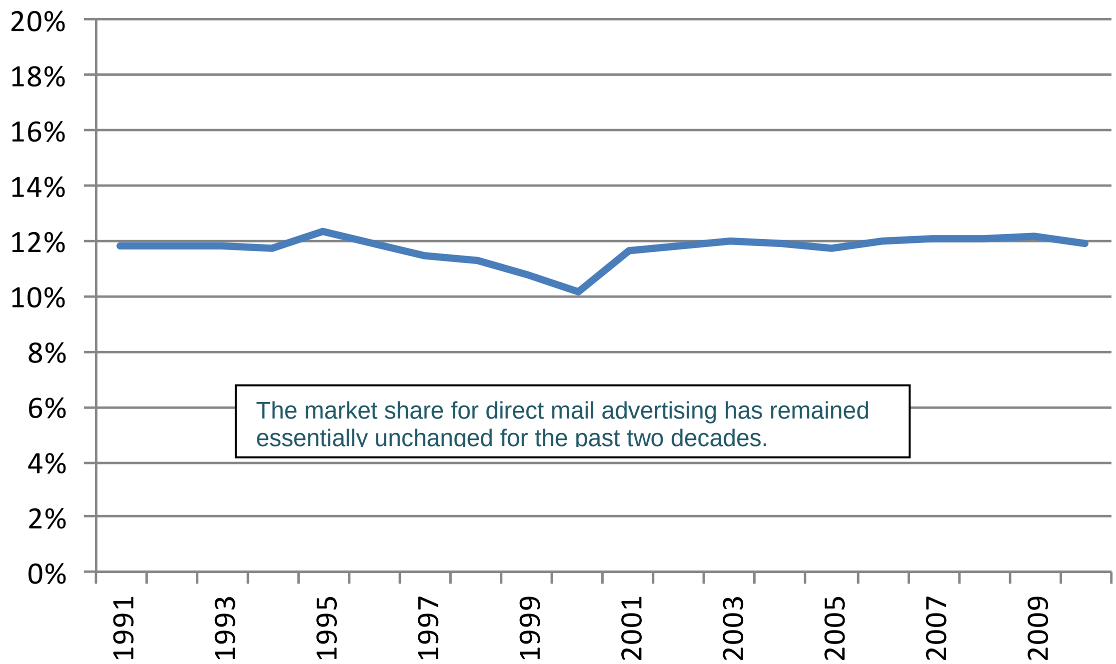
[21] Boston Consulting Group, *Projecting US Mail Volumes to 2020 Final Report – Detail*, March 2, 2010, p.9, http://about.usps.com/future-postal-service/bcg-detailedpresentation.pdf.
[22] U.S. Postal Service, *Direct Testimony of Joseph Corbett on Behalf of the United States Postal Service*, Postal Regulatory Commission Docket No. N2010-1, pp. 8-9, http://www.prc.gov/Docs/67/67421/USPS.T.2.Corbett.pdf.
[23] U.S. Postal Service, *Direct Testimony of Stephen Masse on Behalf of the United States Postal Service*, Postal Regulatory Commission Docket No. N2012-1, http://www.prc.gov/Docs/78/78319/USPS-T-2-Masse.pdf.
[24] U. S. Postal Service, Library Reference USPS-R2010-4R/1, *FY 2008 and FY 2009 Recession-Related Volume Loss Documentation*, Postal Regulatory Commission Docket No. R2010-4(R), FY08.09.Recessn.Conversion.xls. http://www.prc.gov/prc-pages/library/detail.aspx?docketId=R2010-4&docketPart=Documents&docid=77953.

a thing of the past.[25] Books are following a similar path into digital transmission. The proliferation of tablet computers has fueled this transition.

Direct Mail Advertising

One remarkable and encouraging trend over the last decade is the market share of direct mail advertising. Figure 6 shows that the market share for direct mail advertising has remained essentially unchanged for the past two decades.[26] This may be because of two traits that direct mail advertising shares with digital advertising. Both direct mail and digital advertising can be *targeted* to customers by means of mailing lists. And the results of direct mail and digital advertising campaigns can be *quantified*.

Figure 6: Direct Mail as a Share of Total Advertising Spending



Source: U.S. Postal Service Household Diary Study 2010 (Magna Advertising Group data)

The strength of direct mail advertising may also be a consequence of a favorable balance between substitutability and complementarity. Obviously, some digital advertising is a substitute for direct mail. A good example is an e-mail coupon mailed by the local automotive repair shop to its regular customers. In the past, this coupon was probably sent via the mail. Other types of direct mail marketing may work hand in hand with digital advertising or websites. An example is a mailing designed solely to drive customers to a website. As a consequence of mailings such as these, response rates to

[25] Dirk DeYoung, "Mail-order music clubs hit end of playlist," *Minneapolis / St. Paul Business Journal*, June 15, 2011, http://www.bizjournals.com/twincities/blog/everybodys_business/2011/06/end-of-a-music-selling-era.html.
[26] U.S. Postal Service, "The Household Diary Study, Mail Use & Attitudes in FY 2010," April 2011, http://www.prc.gov/Docs/73/73501/USPS_HDS_FY10_FINAL_.pdf, p. 39.

a digital advertising campaign may increase.[27] This does not mean, however that direct mail will be immune to electronic diversion in the future. The BCG forecast of March 2, 2010 assumes "increasing online diversion driven by increased consumer acceptance" [28] resulting in shifting volumes to online alternatives for acquisition and retention mail.[29] Accordingly, Postal Service forecasts assume future volume and revenue loss to digital alternatives.

Packages

One bright spot from the Great Diversion is the potential for gains in package volume from Internet retailers. Parcel Select and Parcel Return Service grew 19 percent from 2007 to 2011.[30] This is remarkable performance considering the state of the economy. In contrast, despite the increasing popularity of the Priority Mail Flat-Rate Box, Priority Mail volumes in total are actually less than they were in 2004. This apparent contradiction is the result of a number of offsetting forces. For example, some Priority Mail flats containing documents are susceptible to electronic diversion. Additionally, some Priority Mail commercial parcel customers find that Parcel Select is an attractive alternative to two- and three-day Priority Mail service, especially during the recession. In another example, many e-tailers such as Amazon.com, offer deferred delivery (via Parcel Select) for free, and charge a premium for faster delivery. Finally, ground parcel service from private sector providers is very competitive with Priority Mail, particularly over short distances.

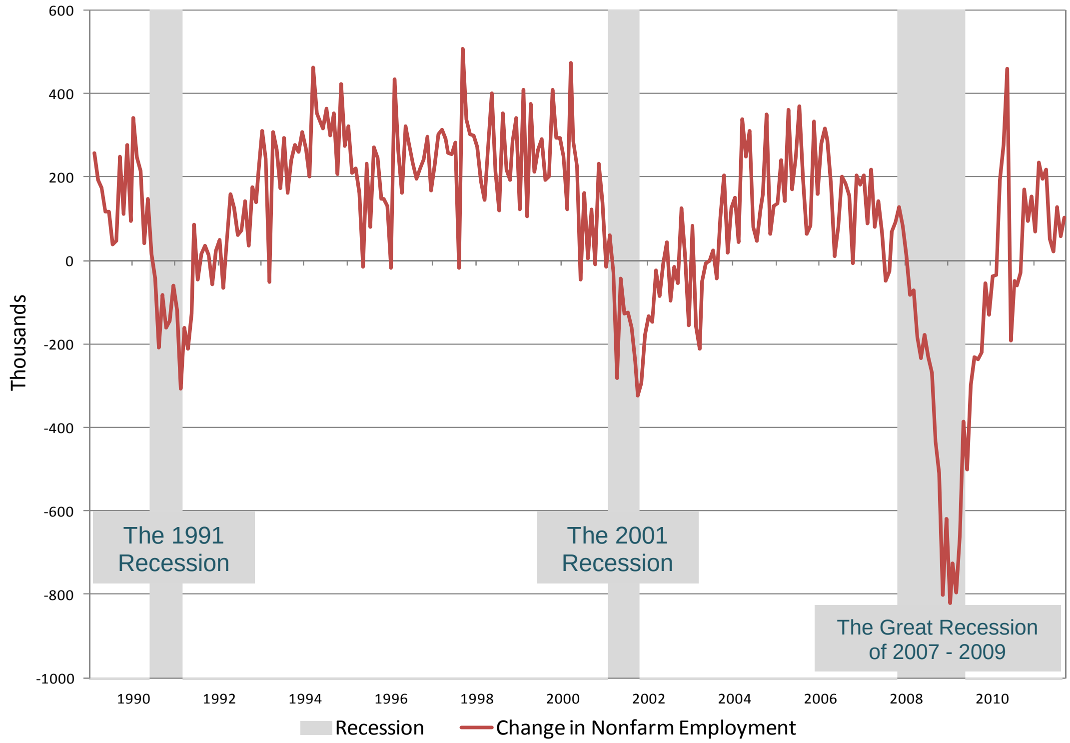
The Great Recession

While the Great Diversion is a long-term, continuing phenomenon, the Great Recession is a story of an abrupt and rapid decline. Not since the 1930s has the American economy been dealt such a severe blow as the Great Recession of 2007 to 2009. According to the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER),[31] there have been three recessions since 1990. The first two recessions both lasted eight months, one from July 1990 to March 1991, and the second from March to November 2001. The 1990-91 and 2001 recessions resulted in job losses of 1.6 million and 2.7 million, respectively. Figure 7 illustrates that, in both of these cases, employment gains did not become consistently positive until well after the official end of the recession. The persistence of unemployment even led the 2001 recovery to be known as the jobless recovery.

Not since the 1930s has the American economy been dealt such a severe blow as the Great Recession of 2007 to 2009.

[27] Alex Batchelor, "Mail 2.0: How Digital Is Driving the Re-invention of Mail," *Journal of Direct, Data and Digital Marketing Practice,* January-March 2008, Vol. 9, pp. 260-273.
[28] Boston Consulting Group, *Projecting US Mail Volumes to 2020 Final Report – Detail*, p.7.
[29] Ibid., p. 9.
[30] Postal Regulatory Commission, *FY 2010 Annual Compliance Report*, Docket No. ACR2010, http://prc.gov/Docs/72/72487/PRC_ACD_2010_UPDATED_1774.pdf, December 29, 2010 and Postal Regulatory Commission, *FY 2008 Annual Compliance Report*, Docket No. ACR2008, December 29, 2008, http://www.prc.gov/Docs/61/61739/ACR.FY2008.Final.pdf.
[31] The National Bureau of Economic Research, "US Business Cycle Expansions and Contractions," http://www.nber.org/cycles/cyclesmain.html.

Figure 7: Month to Month Change in Nonfarm Employment, CY 1989 – CY 2011[32]



Sources: Bureau of Labor Statistics and National Bureau of Economic Research

The 1991 recession had very little effect on the advertising industry. Total advertising spending declined only 1.9 percent in 1991. The 2001 recession was quite different with advertising spending falling 6.2 percent. At the time, this was considered an advertising depression, especially for Internet advertising which declined 12 percent in 2001 and 16 percent in 2002.[33] In contrast, the most recent recession officially lasted 18 months from December 2007 to June 2009. The decline in real Gross Domestic Product led to an economy-wide loss of 8.75 million jobs. With the exception of a hiring spike associated with the decennial census, these job losses persisted into 2010.

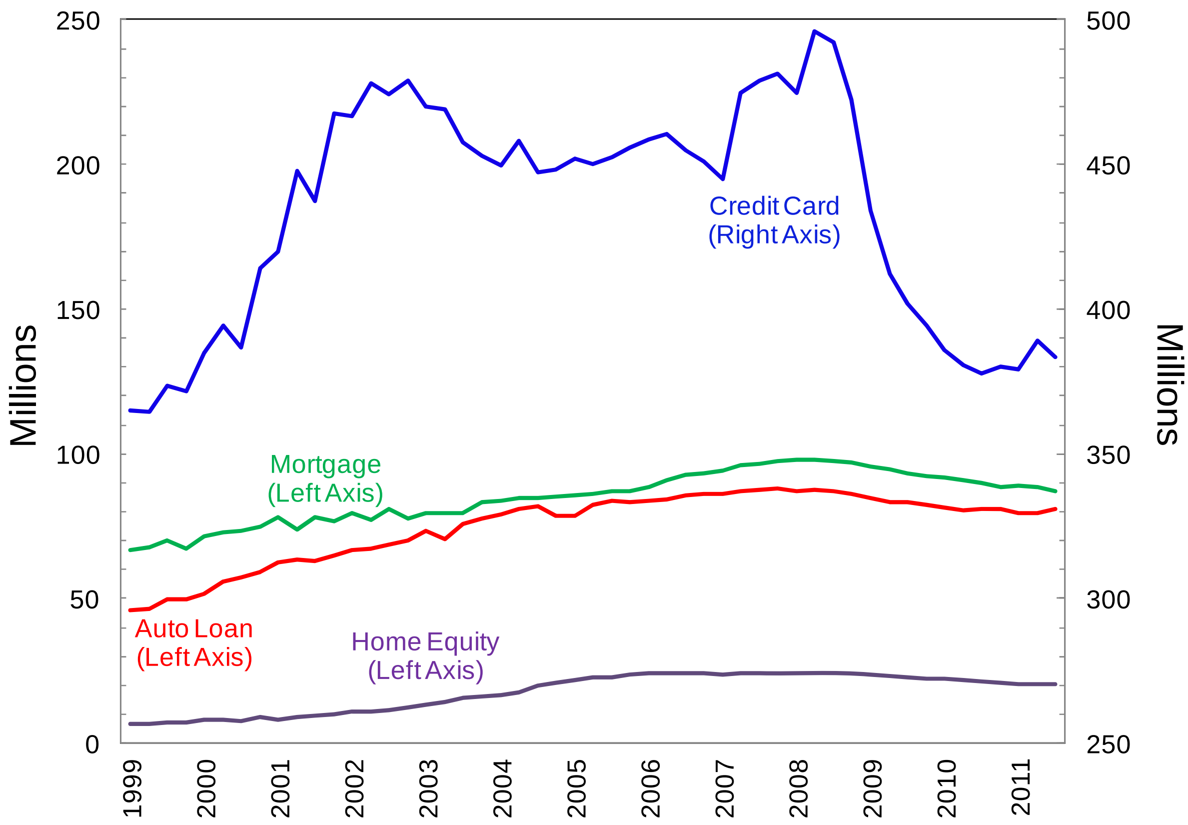
Compared to the Great Recession, the recessions of 1991 and 2001 seem almost innocuous. What made the Great Recession different for the economy as a whole was its cause. Unlike the previous recessions, this recession was caused by a financial panic. The direct impact of the financial aspect of this recession derives from the fact that financial services firms are intensive users of postal services. According to the Postal Service's Household Diary Study 2010, 31 percent of direct mail advertisements were sent by financial services firms in 2005. By 2009, this share had fallen to 23 percent.

[32] CY stands for Calendar Year.
[33] Jeffrey F. Rayport, "Why Online Ads Are Weathering the Recession," *Bloomberg Business Week*, December 24, 2008, http://www.businessweek.com/technology/content/dec2008/tc20081224_411499.htm.

The Great Recession included the collapse of the housing market, which led to millions of foreclosures. Fewer housing units meant, for example, fewer utility bills and fewer mortgage payments. The Great Recession also affected credit cards. Figure 8 shows that since 2008, the economic contraction has caused a 23 percent reduction in the number of credit card accounts.[34]

Since 2008, the economic contraction has caused a 23 percent reduction in the number of credit card accounts.

Figure 8: Number of Accounts by Loan Type, CY 1999 – CY 2011



Source: Federal Reserve Bank of New York

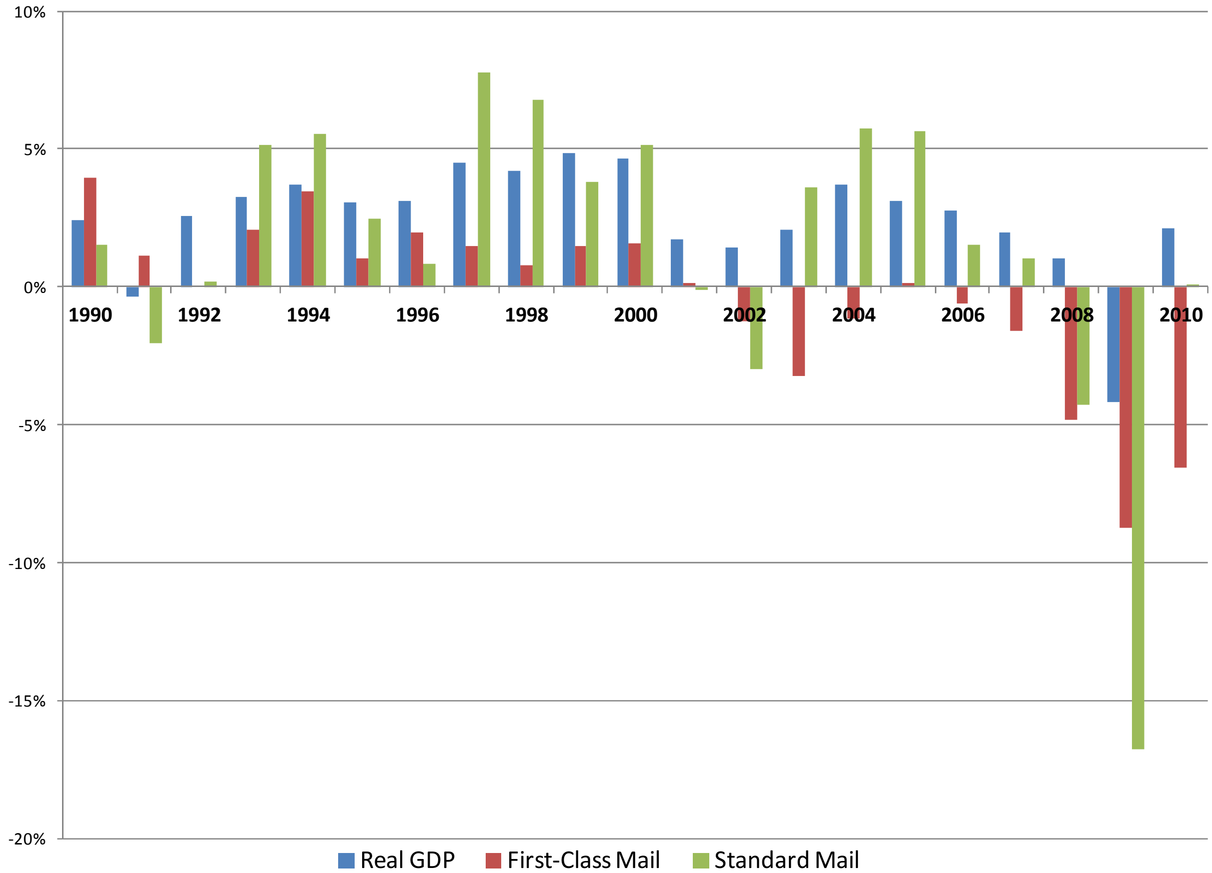
The total number of bills and statements received by households, by any method (hard copy or electronic), fell from a peak of nearly 26 billion to just under 22 billion from FY 2006 to FY 2010.[35] Overall, the transactions component of First-Class Mail fell 17 percent from 2007 to 2010.[36]

Figure 9 shows First-Class and Standard Mail relative to the economy as a whole. The mild recessions of 1991 and 2001 clearly had an adverse effect on the volume of these postal products. First-Class Mail volume growth slowed to a stop in 1992, sustaining the

[34] Federal Reserve Bank of New York, Research and Statistic Group, *Quarterly Report on Household Debt and Credit*, February 2011, http://newyorkfed.org/research/national_economy/householdcredit/DistrictReport_Q42010.pdf.
[35] OIG analysis of U.S. Postal Service Household Diary Studies 2006-2010.
[36] Ibid.

impact of the recession well into the following year. First-Class Mail rebounded somewhat through the 1990s, but declined again from 2000 to 2003. Standard Mail volume growth turned negative in 1991 and began to rebound in 1992, turning strongly positive throughout the rest of the decade. Standard Mail volume also stagnated in 2001 and then declined in 2002 (perhaps, in part, as a result of the Anthrax attacks), only to recover strongly in 2003.

Figure 9: Year over Year Growth in Real GDP, and First-Class Mail and Standard Mail Volumes



Sources: Bureau of Economic Analysis and U.S. Postal Service

The effects of these two recessions, however, pale in comparison to the Great Recession. First-Class Mail, already in decline since 2002 because of electronic diversion, fell into a steep decline in 2008. This decline persisted through 2010, beyond the official end of the recession. This persistence is not surprising given the weakness in job creation and household formation. As bad as the First-Class Mail decline was, it was dwarfed by the decline in Standard Mail. This recession, not the 2001 recession, was a true advertising depression. In 2008, Standard Mail volume declined by 4.3 percent, only slightly worse than the 3 percent decline in 2002. Rather than recovering as it did in 2003, Standard Mail went into a nose dive, falling 16.8 percent more in 2009.

The 2007 recession, not the 2001 recession, was a true advertising depression.

Direct mail advertising from credit card companies was already in decline before the recession. According to the Household Diary Study, advertising mail from financial services firms peaked at 19.9 billion pieces in FY 2006. By 2009 this volume had decreased nearly 36 percent to 12.8 billion pieces. The decline began because mail boxes had become saturated with solicitations from financial services companies. According to Synovate's Mail Monitor ongoing survey, in calendar year (CY) 1998 the credit card industry mailed 3.4 billion solicitations with a response rate of 1.2 percent.[37] By CY 2006, the number of credit card solicitations had more than doubled to nearly 5.8 billion and the response rate had sunk to a paltry 0.2 percent by the first quarter of CY 2006.[38] In light of this pre-existing weakness, the recent financial crisis could not have come at a worse time for Standard Mail.

First-Class Mail and Standard Mail growth are both positively correlated with economic growth. When the economy falls, both First-Class and Standard Mail volumes fall with it. Cyclical declines in First-Class Mail volume are unlikely to be offset by cyclical increases in Standard Mail volumes.

When the economy falls, both First-Class and Standard Mail volumes fall with it.

A closer look at Figure 9 highlights another characteristic of the mail that has important policy implications. The growth rate of First-Class Mail volume over the last 20 years has ranged from a high of 4.9 percent in 1999 to a low of -4.2 percent in 2009, a range of 9.1 percentage points. Over the same time frame, Standard Mail volume growth ranged from a high of 7.8 percent in 1997 to a low of -16.8 percent in 2009, a range of 24.6 percentage points. By this metric, Standard Mail volumes vary by 2.7, or almost three times as much as First-Class Mail volumes.

Advertising mail, which is predominantly Standard Mail, is expected to become a bigger part of the mail stream. Bigger swings from year to year in the Postal Service's workload should be expected, and therefore, resources needed to process, transport, and deliver mail will need to be increasingly flexible.

Another troubling aspect of advertising mail growth is the potential for a re-emergence of environmental concerns. During bad economic times, environmentalism can take a back seat to economic concerns.[39] According to a study by the National Bureau of Economic Research,[40] there is a cyclical component to environmental concerns. When the economy does start to significantly improve, calls for Do Not Mail legislation, which were commonplace before the Great Recession, will increase as well. A related concern with advertising mail growth would be increasingly annoyed or "turned off" mail

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[37] Nadia Oehlsen, "Global Warming Has Issuers Thinking Green," *ATM, Debit & Prepaid FORUM,* October 3-5, 2007, p.22.

[38] Karen Shuggart, "News – Card Mail," *CardTrack.com,* October 16, 2007, http://www.cardtrak.com/news/2007/10/16/Card_Mail and FDIC-Division of Supervision and Consumer Protection, *Risk Management Examination Manual for Credit card Activities,* March 2007, https://www.fdic.gov/regulations/examinations/credit_card/pdf_version/ch5.pdf, p. 24.

[39] Catherine Rampell, "Is Environmentalism a Luxury Good?" *The New York Times*, August 3, 2010, http://economix.blogs.nytimes.com/2010/08/03/is-environmentalism-a-luxury-good.

[40] Matthew E. Kahn and Matthew J. Kotchen, "Environmental Concern and the Business Cycle: The Chilling Effect of Recession," Working Paper No. 16241, National Bureau of Economic Research, July 2010, http://papers.nber.org/papers/w16241.

recipients. During surges in economic activity, direct mail is used increasingly for prospecting. Prospecting mail, which is sent to attract new customers, has a significantly lower response rate than retention mail, which is sent to existing customers. The decline in response rates to credit card solicitations discussed above is indicative of this adverse consumer reaction.

Finally, as its product mix becomes increasingly dominated by direct mail advertising, the imperative of the Postal Service's Universal Service requirement may be weakened. Therefore, the Postal Service needs to diversify its product offerings beyond advertising. New products and services that continue to bind the nation together will be needed.

The Great Slump

Following the Great Recession is the prolonged, lethargic recovery of the American (and, for that matter, global) economy called the Great Slump. The economy seems to follow a different path to recovery with each downturn.[41] It took twenty months for employment to return to its June 1990 pre-recession peak of 109.8 million in February 1992. The employment recovery from the 2001 recession was over twice as long; it returned to February 2000 pre-recession peak of 132.5 million in February 2004, 4 years later. As bad as the latter experience was, the current contraction in employment has been steeper and even longer. Employment peaked at just under 138 million one month into the Great Recession in January 2008. Almost 4 years later, in September 2011, employment remained depressed at only 131.3 million jobs. So why is the economy even slower this time in creating jobs?

Following the Great Recession is the prolonged, lethargic recovery of the American economy called the Great Slump.

There is a new school of thought about this recession. Reinhart and Rogoff,[42] two prominent current day economists, studied the history of economic contractions around the world over the last eight centuries. From their research, they concluded that the recovery from the current financial crisis will be long and slow.[43] They noted that financial crises have a particularly prolonged effect on labor markets: "Over past crises, the duration of the period of rising unemployment averaged nearly 5 years, with a mean increase in the unemployment rate of 7 percentage points, which would bring the U.S. unemployment rate to double digits."[44]

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[41] The National Bureau of Economic Research, the official keeper of recessions, assigns the start and finish dates of each event. As we have already shown, the start of a recession does not necessarily coincide with a slowdown in economic activity, nor does the end date of a recession necessarily mean that the economy is growing robustly.
[42] Carmen M. Reinhart & Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly,* (Princeton: Princeton University Press, 2009).
[43] "What Other Financial Crises Tell Us, The Lesson of History Is Grim: Expect a Prolonged Slump," *Wall Street Journal*, February 3, 2009, http://online.wsj.com/article/SB123362438683541945.html.
[44] Ibid.

Two other prominent economists, Papell and Prodan, have built on Reinhart and Rogoff in more recent research along the same lines.[45] Following the lead of Stanford University professor Robert E. Hall, they called this protracted recovery The Great Slump.[46] Their conclusion was much the same: "The preponderance of evidence for episodes comparable with the current U.S. slump is that, while potential GDP is eventually restored, the slumps last an average of 9 years. If this historical pattern holds, …the Great Slump is not yet half over."[47]

Papell and Prodan estimated that the economy would not fully recover from the recession until the first quarter of FY 2017. In short, the effects of this recession are expected to linger for 9 years.[48] The Postal Service uses IHS Global Insight's (Global Insight) [49] forecast of the macroeconomy to drive its financial forecasting models. Global Insight takes a view similar to that of Reinhart and Rogoff and Papell and Prodan. Global Insight forecasts that private nonfarm employment will not reach pre-recession levels until quarter four of FY 2015. Employment levels, adjusted for population growth, will not return to pre-recession levels between now and 2020.[50]

The bottom line for the Postal Service is fairly grim. Slow employment growth will provide a small stimulus to First-Class Mail volume growth. The effects of this meager stimulus will be inadequate to offset the loss of volume to electronic media. First-Class Mail volumes will continue to decline for the foreseeable future. The financial stress that began with the Great Diversion and considerably worsened with the Great Recession will linger because of the Great Slump.

The financial stress that began with the Great Diversion and considerably worsened with the Great Recession will linger because of the Great Slump.

Managing for Financial Sustainability

A New Corporate Culture

A corporate culture that increases emphasis on financial considerations will strengthen the state of the mail. More than modifying data systems and reports, this is an investment in cultural identity. This would transform the day-to-day marketing and operations of the mail into world-class processes positioned for long-term success. This includes, but is not limited to, sales associates marketing high contribution products

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[45] David H. Papell and Ruxandra Prodan, "The Statistical Behavior of GDP after Financial Crises and Severe Recessions," Federal Reserve Bank of Boston Conference on Long-Term Effects of the Great Recession, University of Houston, October 18-19, 2011, http://www.bos.frb.org/economic/conf/LTE2011/papers/Papell_Prodan.pdf.
[46] Robert E. Hall, "The Long Slump," *American Economic Review 101,* April 2011, http://www.aeaweb.org/articles.php?doi=10.1257/aer.101.2.431, pp. 431–469,.
[47] David H. Papell and Ruxandra Prodan, "The Statistical Behavior of GDP after Financial Crises and Severe Recessions, Abstract.
[48] Ibid., p. 19.
[49] IHS Global Insight provides comprehensive economic, financial, and political coverage of over 200 countries and approximately 170 industries.
[50] Derived from unpublished U. S. Postal Service volume forecasting spreadsheet 2011Q3-1012b-Jan(Split).xls. This forecast underlies Postal Service presentations in August 2011.

instead of high revenue, high cost products; analysts establishing eligibility rules to maximize contribution instead of meeting narrow operational constraints; and management realigning future resources to offset lost contribution.

Table 4 summarizes the estimated contribution margins for each mail segment discussed in The Mail Today section. The Postal Service should develop and disseminate better and more detailed estimates.[51] The process of developing estimates offers critical insight into the mail and develops a sophisticated body of knowledge. Further, it promotes a healthy dialogue within the organization across departmental stovepipes, such as operations, finance, and marketing.

The Postal Service could identify, manage, and market separate mail products with unique cost, contribution, and market characteristics.[52] For example, transactions and correspondence, which face serious headwinds, offer the second and fourth highest contribution margins. It will be a challenge to reenergize and offset losses from these profitable mail segments. This fundamental shift in focus would change how the Postal Service reports and acts upon data. Managing for financial sustainability offers advantages that help leverage strengths, identify opportunities, offset weaknesses, and counter threats. It would inform tough choices and strengthen the state of the mail.

Table 4: Mail Segments by Contribution Margin

Percent Contribution Per Revenue Dollar	
FCM Advertising	66%
FCM Transactions	52%
Overnight Flats & Packages	40%
FCM Correspondence	39%
STD Advertising	34%
Two- and Three-Day Packages	21%
Ground Packages	-18%
Periodicals	-33%

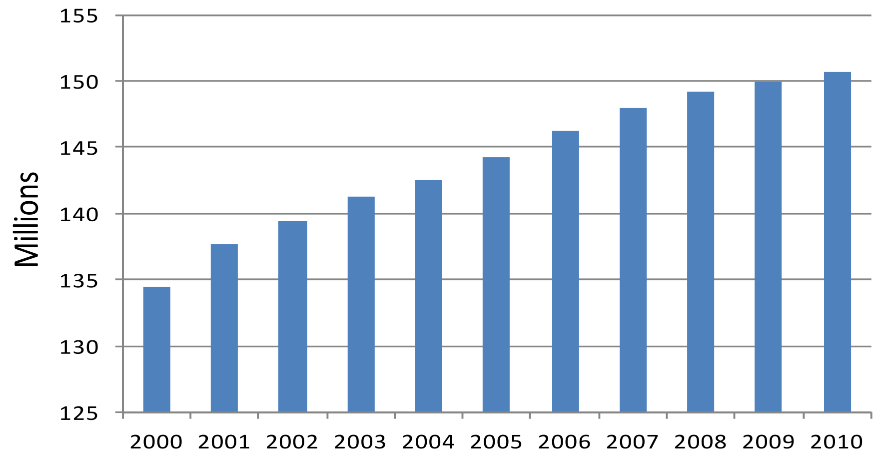
Source: OIG Analysis

Delivery Points

In addition to the loss in volume and contribution, mail delivery costs are ever increasing as the number of delivery points is constantly increasing, roughly by the rate of growth of the adult population. Between 2000 and 2010, the number of delivery points grew 12 percent to 150.7 million, as illustrated in Figure 10.

[51] Detailed estimates could eventually include data by shape, by customer, by geographic area, and/or by season, day of week and/or time of day.
[52] Combining this paradigm with an understanding of external customers' needs would be very powerful and is characteristic of high-performance companies.

Figure 10: Delivery Points, FY 2000 – FY 2010

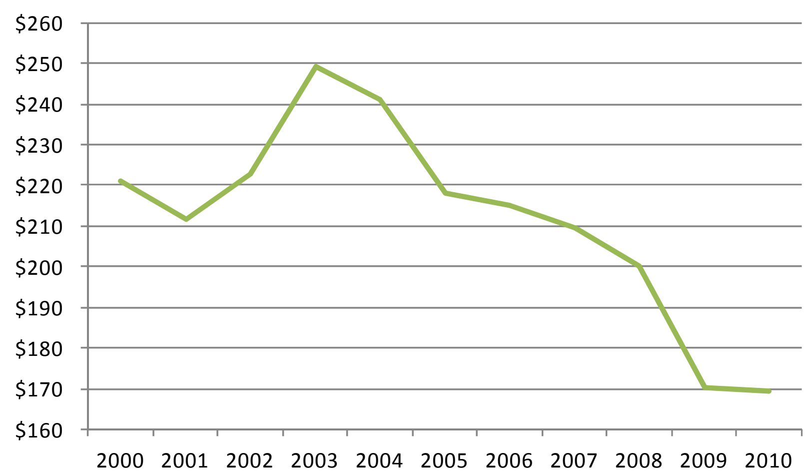


Source: U.S. Postal Service (http://about.usps.com/who-we-are/postal-facts/welcome.htm)

The cost of servicing the delivery network is largely fixed with respect to volume. Carriers must traverse the entire delivery route regardless of the number of pieces of mail. And the opportunities for efficiency gains in street delivery are constrained by the simple fact that increasing the speed of walking or driving from one delivery point to another has its obvious physical limitations.

Figure 11 describes the pattern in product contribution per delivery point per day over the past decade. After adjusting for inflation, contribution per delivery point in 2000 was $221; in 2007 contribution had fallen to $210, an average annual decline of 0.7 percent. From 2007 to 2009, the contribution decline accelerated. Product contribution stabilized at $169 per delivery point in 2010, a decline of 23 percent since 2000.

Figure 11: Annual Product Contribution per Delivery Point in Constant 2010 Dollars



Source: OIG Analysis

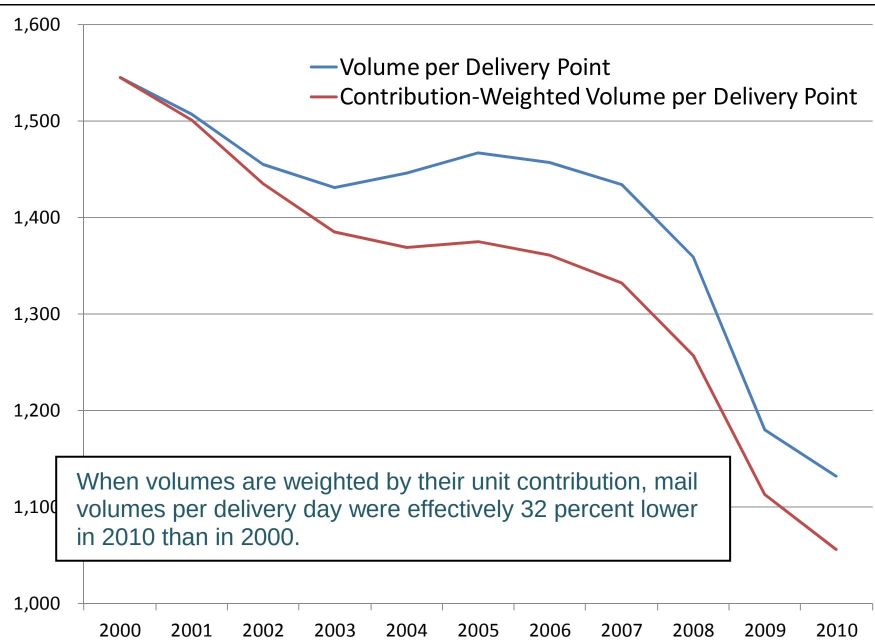
Contribution Weighted Volume Index

A case can be made that part of the decline in product contribution per delivery point per year is attributable to changes in how retirement-related obligations are treated in the product costing system. This problem may be circumvented by re-calculating the product costing so that the last 10 years are consistent with one another; however, this is a daunting proposition. As shown in Figure 12, an alternative way of depicting the downward trend is to adjust the data on delivery point volume using a weighting mechanism to account for the different contribution margins on separate postal products. This method places more emphasis on high-contribution products. In this way, the disparity in contribution across products is accounted for, holding product costing methodologies constant.

In 2000, mail volume per delivery point was 1,545 pieces, a little more than 5 pieces per delivery day. By 2010, mail volume per delivery point had declined 27 percent to 1,132 pieces (nearly 4 pieces per delivery day). Financially, the decline felt considerably worse. When volumes are weighted by their unit contribution, mail volumes per delivery day were, effectively, 32 percent lower in 2010 than in 2000.

Most of the gap between actual volumes and contribution-weighted volumes occurred before the recession. This is the effect of electronic diversion. During the recession, the advertising market, including direct mail advertising (mostly Standard Mail), were devastated. The relatively large loss of Standard Mail caused the two lines to move closer together as they both plunge. The steep decline is the recession; the convergence is the result of losing more Standard Mail than First-Class Mail.

Figure 12: Annual Contribution-Weighted Volume Index



Sources: OIG Analysis, U.S. Postal Service Cost and Revenue Analysis (CRA) Reports and PRC Annual Compliance Determinations (ACD)

Pricing, Contribution, and Customers

The decline in contribution-weighted volume per delivery point presents a troubling new reality. There are several possible solutions to this problem. On the cost side, optimization of the retail and processing networks, as well as five-day delivery, have been proposed. To date, these efforts have proven to be controversial and have not yet yielded substantial results. Alternatively, the Postal Service could introduce nontraditional new products and services, but these would require Congressional or regulatory approval. Price decreases or volume discounts to stimulate sales of current products have either not succeeded or, as in the case of competitive products, have not been of sufficient scale to offset the adverse financial trend. In any case, since the decline in contribution-weighted volume per delivery point has not been caused by increased postal prices, price reductions are not likely to be an effective remedy. Price increases to raise revenue, on the other hand, remain an option.

The effect of postal prices on the demand for postal services in the Internet age is highly complex. Critics of price increases point to the Internet, asserting that raising prices will exacerbate the financial problem by driving even more customers away from the mail. In effect, they are saying that the existence of the Internet has increased the price sensitivity of demand for postal products. As we have already seen, the effect of the Internet on postal products, particularly First-Class Mail, has been evident since the mid-1990s. In that time, First-Class Mail prices have increased numerous times without a discernable effect on the pace of electronic diversion. An examination of the data indicates that the decline in First-class volume is largely independent of changes in postal prices. As Professor Daniel Spulber of the Kellogg School of Management at Northwestern University, testifying on behalf of advertising mailers, so colorfully stated over 15 years ago.[53]

> Technological and market changes are increasing the benefits and reducing the costs of electronic transmission. These factors are responsible for the rapid expansion of electronic transmission. These ongoing and fundamental changes are entirely independent of postal rates. They can no more be diverted or slowed by a change in postal rates than a reduction in the cost of feeding horses would have halted the development of the automobile.[54]

Conversely, raising prices will not likely increase the overall pace of diversion.[55] It is not surprising, therefore, that, even in the presence of the Internet, the response of postal

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[53] One might be tempted to say that this perspective is obsolete. However, J. Gregory Sidak, a well-known expert in the telecommunications law and economics, agreed under cross examination by the Postal Service that it was still true 12 years later. Postal Rate Commission Docket No. R2006-1, *Postal Rate and Fee Changes, 2006,* Tr. 32/10876, http://www.prc.gov/Docs/55/55218 /Vol-32-11-29-2006.pdf.

[54] *Rebuttal Testimony of Daniel F. Spulber on behalf of Advertising Mail Marketing Association, Mail Advertising Service Association International, Direct Marketing Association, and Mail Order Association of America*, Postal Rate Commission Docket No. R94-1, *Postal Rate and Fee Changes, 1994,* AMMA et. al.-RT-2, http://www.prc.gov/prcarchive/viewpdf.aspx?docid=28551, p. 12.

[55] In fact, the Postal Service has used Professor Spulber's words in defense of subsequent price increases. United States Postal Service, *Initial Brief of the United States Postal Service*, Postal Rate Commission Docket No. R2006-1, pp. 40 – 42, http://www. prc.gov/Docs/55/55476/Initial_Brief_-_FINAL.pdf. As recently as August 1, 2011, the Postal

customers to moderate and predictable price increases has not been dramatic, and has resulted in higher postal revenues.

However, price increases need to be made with careful consideration of other policy objectives and factors, such as those listed in PAEA.[56] Policy makers should be mindful that these price changes do not further reduce the richness of the mix of mail to recipients and that is strongly connected to the Postal Service's core mission of binding the nation together.

Conclusion

The Postal Service is in a state of unprecedented financial stress caused by three major trends: the Great Diversion, the Great Recession and the Great Slump. Despite these trends, it is clear that the Postal Service product portfolio contains several very viable, high contribution products that American businesses and consumers value. We believe that the Postal Service can have a financially stable future, but such an outcome will require a shift in public policy and corporate culture that emphasizes the value of mail and its contribution (the amount of revenue over and above the cost) over other concerns, such as a narrow focus on volume recovery.

Service used the Commission's acceptance of this argument in defense of its exigent price increase. *Reply Comments of the United States Postal Service Regarding Court Remand*, Postal Regulatory Commission Docket No. R2010-4R, *Rate Adjustment Due to Extraordinary Circumstances,* http://www.prc.gov/Docs/74/74367/Rmnd.Reply.Cmmtns.pdf, pp. 38 – 39.

[56] Postal Accountability and Enhancement Act, P.L. 109-435, 39 U.S.C. § 3622(b) and (c).

Appendices

Appendix A Mail Market Definitions

First-Class Mail Correspondence

First-Class Mail correspondence includes letters, flats, and postcards sent among households and between households and nonhouseholds.[57] This mail is used to establish or maintain relationships and deliver personal and business communications including handwritten or typewritten letters, greeting cards, invitations, and announcements.[58] In this way, First-Class Mail correspondence contributes to the mail moment[59] and keeps the mailbox valuable. We expect this mail to have general mail characteristics similar to single-piece mail. This mail is a premium product for the Postal Service with a service standard of one to three days.

First-Class Mail correspondence volume was 14.6 billion pieces, revenue was $6.5 billion, and contribution was $2.5 billion in FY 2010. This accounted for 9 percent of total volume, 11 percent of total revenue, and 10 percent of contribution. Of the eight mail segments, First-Class Mail correspondence has the third largest revenue while contributing the fourth largest contribution.

Table A-1 shows that First-Class Mail correspondence had a contribution per piece of $0.17, which equates to a contribution per revenue dollar, or contribution margin, of 39 percent. This margin ranks as fourth highest out of the eight mail segments.

Table A-1: First-Class Mail Correspondence – FY 2010 Unit Estimates[60]

First-Class Mail Correspondence		
Unit Revenue (UR)	$	0.446
Unit Cost (UC)	$	0.272
Unit Contribution (UR-UC)	$	0.174
Contribution Per Revenue Dollar	$	0.390

Source: OIG Analysis

First-Class Mail Transactions

First-Class Mail transactions includes letters, flats, and postcards sent among households and between households and nonhouseholds. This mail is used to conduct financial transactions and includes bills, payments, account statements, donations,

[57] Consistent with the HDS, this mail segment excludes nonhousehold-to-nonhousehold mail.
[58] This section relies on HDS data reported as correspondence mail that include secondary advertising mail also reported as advertising mail.
[59] The unique time when consumers bring mail into their home, sort, review, and act on it.
[60] These data are based on an OIG analysis of RPW and CRA data. Any discrepancies between total and unit estimates are caused by discrepancies between RPW and revised CRA data.

rebates, and mail orders.[61] Because transactions likely originate in bulk and trigger individual responses, we expect this mail to have general mail characteristics similar to both workshared and single-piece mail, respectively. This mail is a premium product for the Postal Service with a service standard of one to three days.

First-Class Mail transactions volume was 35.9 billion pieces,[62] revenue was $15.2 billion, and contribution was $7.9 billion in FY 2010. That is, this mail accounted for 21 percent of total volume, 25 percent of total revenue, and 32 percent of contribution.

Table A-2 shows that First-Class Mail transactions had a contribution per piece of $0.22. This equates to the second highest contribution margin among the mail segments at 52 percent; for every dollar of revenue, this mail contributes 52 cents in contribution. Considering also that it has the second highest volume and revenue among the mail segments, First-Class Mail transactions are of great significance to the Postal Service.

Table A-2: First-Class Mail Transactions – FY 2010 Unit Estimates

First-Class Mail Transactions		
Unit Revenue (UR)	$	0.422
Unit Cost (UC)	$	0.201
Unit Contribution (UR-UC)	$	0.221
Contribution Per Revenue Dollar	$	0.523

Source: OIG Analysis

First-Class Mail Advertising

First-Class Mail advertising includes letters, flats, and postcards received by households. This mail is used to deliver sales-related messages and includes advertising, promotional, and sales material.[63] Because advertising likely originates in bulk, we expect this mail to have general mail characteristics similar to workshared mail. This mail is a premium product for the Postal Service with a service standard of one to three days.

First-Class Mail advertising volume was 6.2 billion pieces, revenue was $2.1 billion, and contribution was $1.4 billion in FY 2010. This mail accounted for 4 percent of total volume, 4 percent of total revenue, and 6 percent of contribution.

Table A-3 shows that First-Class Mail advertising had a contribution per piece of $0.23. This equates to a contribution margin of 66 percent; hence, for every dollar of revenue, this mail contributes 66 cents in contribution, the highest margin of the eight mail

[61] This section relies on HDS data on transactions mail that include secondary advertising mail also reported as advertising mail.
[62] Transactions account for 62 percent of total First-Class Mail volume, making it the largest subset.
[63] This section relies on HDS data on advertising mail that includes secondary advertising mail also reported as correspondence and transactions mail.

segments. Considering these statistics, First-Class Mail advertising is a major and important mail segment.

Table A-3: First-Class Mail Advertising – FY 2010 Unit Estimates

First-Class Mail Advertising		
Unit Revenue (UR)	$	0.346
Unit Cost (UC)	$	0.117
Unit Contribution (UR-UC)	$	0.229
Contribution Per Revenue Dollar	$	0.662

Source: OIG Analysis

Standard Mail Advertising

Standard advertising includes letters and flats[64] that weigh less than 16 ounces sent among households and nonhouseholds. This mail is used to deliver sales-related messages and includes flyers, circulars, pamphlets, catalogues, newsletters, and promotional materials, and cannot be used to deliver personal correspondence, handwritten or typewritten letters, or bills and statements. Standard advertising is bulk-entered with a three to ten day service standard and has similar mail characteristics to workshared mail.

Standard advertising volume was 81.8 billion pieces, revenue was $16.7 billion, and contribution was $5.6 billion in FY 2010. This mail accounted for 48 percent of total volume, 28 percent of total revenue, and 23 percent of contribution.

Table A-4 shows that Standard advertising had a contribution per piece of $0.07. This equates to a contribution margin of 34 percent; for every dollar of revenue, this mail contributes 34 cents in contribution, the fifth highest margin of the eight mail segments. The Standard advertising mail segment, with the highest volume and revenue of all eight mail segments, has great significance.

Table A-4: Standard Mail Advertising – FY 2010 Unit Estimates

Standard Mail Advertising		
Unit Revenue (UR)	$	0.203
Unit Cost (UC)	$	0.135
Unit Contribution (UR-UC)	$	0.069
Contribution Per Revenue Dollar	$	0.337

Source: OIG Analysis

[64] Standard parcels are included in the Ground Packages mail segment.

Periodicals

Periodicals includes magazines, newspapers, and other publications[65] that are issued at regular, specified intervals. The primary purpose of this mail is to transmit information. Periodicals has educational, cultural, scientific, and informational value. It is a preferred product for the Postal Service with a service standard of one to seven days. It may be entered in bulk and shares similar characteristics to workshared mail.

Periodicals volume was 7.3 billion pieces, revenue was $1.9 billion, and contribution was negative $0.6 billion in FY 2010. This mail accounted for 4 percent of total volume and 3 percent of total revenue.

Table A-5 shows that Periodicals had a contribution per piece of negative $0.08. This equates to a contribution margin of negative 33 percent; hence, for every dollar of revenue, this mail results in a net loss of 33 cents.

Table A-5: Periodicals – FY 2010 Unit Estimates

Periodicals		
Unit Revenue (UR)	$	0.258
Unit Cost (UC)	$	0.343
Unit Contribution (UR-UC)	$	(0.084)
Contribution Per Revenue Dollar	$	(0.325)

Source: OIG Analysis

Two- and Three-Day Packages

Two- and Three-Day Packages consists of First-Class Mail parcels weighing less than 13 ounces and Priority Mail. Priority Mail accounts for nearly two-thirds of this mail segment's volume. This mail is used to deliver documents, merchandise, and goods. It is a premium product for the Postal Service with a service standard of one to three days for which the Postal Service provides preferential handling and expedited delivery, but does not guarantee service. The Postal Service offers Saturday and residential delivery at no additional cost and with no fuel surcharges.

Two- and Three-Day Packages volume was 1.1 billion pieces, revenue was $5.7 billion, and contribution was $1.4 billion in FY 2010. This mail accounted for 1 percent of total volume, 9 percent of total revenue, and 6 percent of contribution.

Table A-6 shows that Two- and Three-Day Packages had a contribution per piece of $1.02. This is a relatively high unit contribution and for every dollar of revenue, this mail contributes 21 cents in contribution. This is the sixth highest margin of the eight mail segments.

[65] According to OIG analysis of HDS data, magazines account for 78 percent and newspapers account for 22 percent of Periodicals received by households. HDS 2010, p. 49 (Figure 6.2).

Table A-6: Two- & Three-Day Packages – FY 2010 Unit Estimates

Two- & Three-Day Packages		
Unit Revenue (UR)	$	4.905
Unit Cost (UC)	$	3.887
Unit Contribution (UR-UC)	$	1.018
Contribution Per Revenue Dollar	$	0.208

Source: OIG Analysis

Overnight Flats and Packages

Overnight Flats and Packages consists of Express Mail which is used to deliver time-sensitive letters, documents, merchandise, and goods. This is a premium product for the Postal Service with a service standard of one to two days and guaranteed delivery either overnight or on the second day to most domestic addresses. The Postal Service offers Saturday and residential delivery at no additional cost, with no fuel surcharges, and free tracking information.

Overnight Flats and Packages volume was 43 million pieces, revenue was $0.8 billion, and contribution was $0.3 billion in FY 2010. This mail accounted for less than one third of one percent of total volume, 1.4 percent of total revenue, and 1.3 percent of total contribution.

Table A-7 shows that Overnight Flats and Packages had a contribution per piece of $7.81. This is a relatively high unit contribution and equates to a contribution margin of 40 percent. This is the third highest margin of the eight mail segments.

Table A-7: Overnight Flats & Packages – FY 2010 Unit Estimates

Overnight Flats & Packages		
Unit Revenue (UR)	$	19.456
Unit Cost (UC)	$	11.646
Unit Profitability (UR-UC)	$	7.810
Profit Per Revenue Dollar	$	0.401

Source: OIG Analysis

Ground Packages

Ground Packages includes Standard parcels, Parcel Select, and Package Services.[66] This mail is used to deliver small and large packages including product samples, merchandise, goods, books, and sound recordings. The service standard for Ground Packages products is 2 to 8 days with the exception of Standard parcels, for which the

[66] Package Services includes Parcel Post, Bound Printed Matter, Media Mail, and Library Mail.

service standard is 3 to 10 days. The Postal Service offers Saturday and residential delivery at no additional cost and with no fuel surcharges.

Ground Packages volume was 1.3 billion pieces, revenue was $2.1 billion, and contribution was negative $38 million in FY 2010. This mail accounted for 1 percent of total volume and 3 percent of total revenue.

Table A-8 shows that Ground Packages had a contribution per piece of negative $0.28. This equates to a contribution margin of negative 18 percent; for every dollar of revenue, this mail results in a net loss of 1.8 cents.

Table A-8: Ground Packages – FY 2010 Unit Estimates

Ground Packages		
Unit Revenue (UR)	$	1.565
Unit Cost (UC)	$	1.840
Unit Contribution (UR-UC)	$	(0.275)
Contribution Per Revenue Dollar	$	(0.175)

Source: OIG Analysis

Appendix B Outlook Assessments by Mail Segment

To compute the overall outlook assessment per mail segment, we assembled each mail segment's Strengths, Weaknesses, Opportunities and Threats (SWOT) factors, and also rated each mail segment along the following three outlook evaluation factors as challenged, neutral and promising.

- Threat – Are there existing or emerging threats to the mail segment?
- Lack of Countermeasures – Can the Postal Service counter or avoid the threats?
- Impact – What are the potential financial impacts of these threats on the Postal Service? How likely are they to occur?

We combined our professional judgment of these factors to compute the overall outlook assessment again as challenged, neutral and promising. *There is no set formula or causal relationship between the magnitude of the three factors and the overall outlook assessment.*

<u>Challenged Outlook</u> – This mail segment, color coded red, has a challenged outlook as its fundamentals are trending negative. The mail segment faces major challenges and hurdles. Future impacts on the Postal Service are likely profound. The only solution may be a fundamental change in business strategy.

<u>Neutral Outlook</u> – This mail segment, color coded yellow, faces equal challenges and opportunities. Future impacts on the Postal Service may be negative or positive. Active and smart management of the mail segment is key to counter threats and exploit opportunities.

<u>Promising Outlook</u> – This mail segment, color coded green, has a promising outlook due to its strong fundamentals. The mail segment may face threats, but also may enjoy opportunities. Future impacts on the Postal Service are potentially positive. Management may leverage strengths to lead to positive future results.

Presented here are the SWOT and outlook factors by mail segment.

First-Class Mail Correspondence

The Postal Service classifies the First-Class Mail correspondence segment as market dominant and a subset of Mailing Services.

Table B-1: First-Class Mail Correspondence – SWOT Factors

Strengths & Opportunities	Weaknesses & Threats
Unique characteristics of emotional content mail	Electronic diversion
	Environmental movements

Source: OIG Analysis

Table B-2: First-Class Mail Correspondence – Outlook Factors

<table>
<tr><th colspan="3">Overall Outlook Assessment: Challenged</th></tr>
<tr><td>Threat</td><td>High</td><td>▪ Electronic substitutes are a current and growing threat.</td></tr>
<tr><td>Lack of Countermeasures</td><td>High</td><td>▪ Options to mitigate or avoid threats are limited.</td></tr>
<tr><td>Impact</td><td>Medium</td><td>▪ Important mail segment
o 14.6 billion pieces, $6.5 billion in revenue, and $2.5 billion in contribution in FY 2010.
o Correspondence mail contributes to the mail moment and keeps the mailbox valuable.
o Every revenue dollar lost results in a 39 cents loss in contribution.</td></tr>
</table>

Source: OIG Analysis

First-Class Mail Transactions

The Postal Service classifies the First-Class Mail transactions mail segment as market dominant and a subset of Mailing Services.

Table B-3: First-Class Mail Transactions – SWOT Factors

Strengths & Opportunities	Weaknesses & Threats
Value of hard copy records	Electronic bill presentation and payment (EBPP)
Value-added services — information rich mail stream	

Source: OIG Analysis

Table B-4: First-Class Mail Transactions – Outlook Factors

Overall Outlook Assessment: Challenged		
Threat	High	▪ EBPP is a formidable and existing threat. ▪ This mail is sensitive to economic downturns.
Lack of Countermeasures	High	▪ Options to mitigate or avoid threats are limited.
Impact	High	▪ Critical mail segment o 35.9 billion pieces, \$15.2 billion in revenue, and \$7.9 billion in contribution in FY 2010 o Every dollar loss in revenue loses 52 cents in contribution. Difficult for other mail segments to replace lost contribution.

Source: OIG Analysis

First-Class Mail Advertising

The Postal Service classifies First-Class Mail advertising as market dominant and a subset of its Mailing Services.

Table B-5: First-Class Mail Advertising – SWOT Factors

Strengths & Opportunities	Weaknesses & Threats
High response rates	Alternative advertising media including Internet
Targeted advertising	Diversion to Standard mail and lower contribution per piece
Complementary effect from multichannel marketing	Do-Not-Mail initiatives
Value-added services — information rich mail stream	Negative economic trends
Annoyance with email spam and laws against spam (CANSPAM)	

Source: OIG Analysis

Table B-6: First-Class Mail Advertising – Outlook Factors

Overall Outlook Assessment: Promising		
Threat	Medium	▪ Unique combination of response rates, costs, and average order values offers potent alternative to competing advertising channels. ▪ Standard mail advertising may be a low cost alternative. ▪ Potential Do-Not-Mail registries affect subset of mail. ▪ This mail is sensitive to economic downturns.
Lack of Countermeasures	Low	▪ Opportunity to build upon complementary effect of multichannel marketing. ▪ Consumers value direct mail.
Impact	Medium	▪ Important mail segment o 6.2 billion pieces, $2.1 billion in revenue, and $1.4 billion in contribution in FY 2010 o Every dollar loss in revenue loses 66 cents in contribution; other mail segments may only replace portion of lost contribution.

Source: OIG Analysis

Standard Mail Advertising

The Postal Service classifies Standard advertising as market dominant and a subset of its Mailing Services.

Table B-7: Standard Advertising – SWOT Factors

Strengths & Opportunities	Weaknesses & Threats
High response rates	Negative economic trends
Targeted advertising (e.g., geographic and demographic)	Alternative advertising media including Internet
Complementary effect from multichannel marketing	Do-Not-Mail initiatives
Value-added services — information rich mail stream	
Annoyance with email spam and laws against span (CANSPAM)	

Source: OIG Analysis

Table B-8: Standard Advertising – Outlook Factors

Overall Outlook Assessment: Promising		
Threat	Medium	▪ Unique combination of response rates, costs, and average order values offers potent alternative to competing advertising channels. ▪ Potential Do-Not-Mail registries affect subset of mail. ▪ This mail is sensitive to economic downturns.
Lack of Countermeasures	Low	▪ Opportunity to build upon complementary effect of multichannel marketing. ▪ Consumers value direct mail.
Impact	High	▪ Critical mail segment o 81.8 billion pieces, \$16.7 billion in revenue, and \$5.6 billion in contribution in FY 2010. o Every dollar loss in revenue loses 34 cents in contribution.

Source: OIG Analysis

Periodicals

The Postal Service classifies Periodicals as market dominant and a subset of its Mailing Services.

Table B-9: Periodicals – SWOT Factors

Strengths & Opportunities	Weaknesses & Threats
High value of content	Increasing competition from the Internet
Anchor of the mail box and the mail moment	Negative advertising expenditures trends
	Demographic trends of reading decline

Source: OIG Analysis

Table B-10: Periodicals – Outlook Factors

Overall Outlook Assessment: Challenged		
Threat	High	▪ The Internet is a formidable and existing threat.
Lack of Countermeasures	High	▪ Options to mitigate or avoid threats are limited.
Impact	Medium	▪ Important mail segment o 7.3 billion pieces, $1.9 billion in revenue, and $611 million loss in FY 2010. o Average contribution margin is negative 33 percent. ▪ Volume declines affect other mail segments and how customers value the mail moment.

Source: OIG Analysis

Two- and Three-Day Packages

The Postal Service classifies First-Class Mail and Priority Mail parcels as market dominant and a subset of its Mailing Services.

Table B-11: Two- & Three-Day Packages – SWOT Factors

Strengths & Opportunities	Weaknesses & Threats
Competitive prices	Competitors entering market
Expansion into higher revenue, heavier packages	No guaranteed service standard
Valued-added services — information rich mail stream	Limited value-added services

Source: OIG Analysis

Table B-12: Two- & Three-Day Packages – Outlook Factors

Overall Outlook Assessment: Promising		
Threat	Low	▪ Low-price offerings offset the threat from new competition.
Lack of Countermeasures	Low	▪ Commanding market share offers economies of scale.
Impact	Medium	▪ Important mail segment o 1.1 billion pieces, \$5.7 billion in revenue, and \$1.4 billion in contribution in FY 2010. o Every dollar loss in revenue loses 21 cents in contribution.

Source: OIG Analysis

Overnight Flats and Packages

The Postal Service classifies Overnight Flats and Packages (includes Express Mail) as a competitive product and a subset of its Shipping Services.

Table B-13: Overnight Flats & Packages – SWOT Factors

Strengths & Opportunities	Weaknesses & Threats
Guaranteed service standard	Entrenched competition
Niche markets — government	Minor market share
Valued-added services — information rich mail stream	Limited value-added services
	Shrinking market, especially in a down economy
	Electronic diversion

Source: OIG Analysis

Table B-14: Overnight Flats & Packages – Outlook Factors

Overall Outlook Assessment: Neutral		
Threat	Medium	▪ Entrenched competition has advantages and is a strong threat, but already dominates market.
Lack of Countermeasures	Medium	▪ Minor market share offers competitive disadvantages. ▪ Low brand attractiveness presents challenge.
Impact	Low	▪ Small mail segment o 43 million pieces, $828 million in revenue, and $332 million in contribution in FY 2010. o Every dollar loss in revenue loses 40 cents in contribution.

Source: OIG Analysis

Ground Packages

The Postal Service classifies Standard parcels, single-piece Parcel Post, Bound Printed Matter, Media Mail, and Library Mail as market dominant and a subset of its Mailing Services. It considers Parcel Select as a competitive product and a subset of its Shipping Services.

Table B-15: Ground Packages – SWOT Factors

Strengths & Opportunities	Weaknesses & Threats
Competitive prices	Entrenched competition
Expansion into higher revenue, heavier packages	No guaranteed service standard
Long distance shopping	Limited value-added services
First and last mile expertise	
Valued-added services — information rich mail stream	

Source: OIG Analysis

Table B-16: Ground Packages – Outlook Factors

Overall Outlook Assessment: Neutral		
Threat	Medium	▪ Entrenched and growing competition has advantages and is a strong threat, and dominates heavier weight packages.
Lack of Countermeasures	Low	▪ Growth in long distance shopping complements ground packages. ▪ First and last mile offers advantages.
Impact	Medium	▪ Moderate mail segment o 1.3 billion pieces, $2.1 billion in revenue, and $368 million loss in FY 2010. o Average contribution margin is negative 18 percent.

Source: OIG Analysis