



STATEMENT BY  
ADVO, INC.  
TO THE PRESIDENT'S COMMISSION ON THE  
UNITED STATES POSTAL SERVICE

February 12, 2003

“For nearly 50 years, ADVO, Inc. relied exclusively on the Postal Service to deliver our household advertising products. Recently, however, ADVO has moved more than 7% (or 240 million mail pieces) of our annual three billion shared mail package volume into private delivery, through a combination of our own delivery networks and joint partnerships with newspapers. As the largest customer of the Postal Service, we obviously prefer the mail, but postage cost is a critical competitive factor for our company, constituting half of our total expenses. Our private delivery operations can deliver our products for a cost that is 33-50% below postal distribution costs. As postal rates rise, that spread can become the determining factor in our ability to remain price-competitive with non-postal advertising distributors such as newspapers and private delivery companies. Let there be no doubt, whatever happens we *will* grow our business. We *want* to grow our *postal* volume, but we can only do so if postal rates are predictable, affordable and competitive.”

Gary M. Mulloy  
Chairman & Chief Executive Officer  
ADVO, Inc.  
ADVO, Inc., February 12, 2003



## **EXECUTIVE SUMMARY**

The long-term viability of the Postal Service is uncertain. It faces increasing competition for core products, from both electronic alternatives and hard-copy delivery competitors, but has little control over its pricing or costs, and faces large long-term liabilities. Reform is essential to preserve the Postal Service and ensure that it can continue to reliably and affordably serve the needs of the American public, businesses, and the economy in the 21st Century. To accomplish this, ADVO recommends the following:

### **PRESERVE UNIVERSAL SERVICE**

- Mail delivery to all households six days a week is a key element of the value of the Postal Service to senders and recipients, businesses and citizens alike. The Commission should identify the structure and tools the USPS needs to ensure the survival of universal service.

### **STRENGTHEN THE POSTAL SERVICE'S BALANCE SHEET**

- The current overfunding of pension costs must be corrected by legislation to remove the deferred retirement liability from the balance sheet. The passage of this legislation will provide the time necessary for the recommendations of the Commission to be debated, enacted, and executed.
- Workers' Compensation costs must be brought under control, perhaps by switching from the current civil service program to those used by numerous states and private commercial firms that close cases rather than leaving them unresolved and open-ended.
- The unfunded retiree health benefits liability should be transferred to the U.S. Treasury on a one-time basis as a means of strengthening the business to be self-funded going forward.
- Employee benefit costs, incurred from this point forward, should be accrued and funded under generally accepted accounting principles just as is done in private industry.

### **EMPOWER A PROCESS THAT YIELDS A COMPETITIVE PRICING STRATEGY**

- Encourage partnerships and create incentives for reseller relationships.
- Rebalance priorities: Marketing and Sales should have parity with Operations.

### **THE POSTAL SERVICE SHOULD OFFER PAYMENT TERMS TO MAILERS**

- Consistent with the common practice of commercial firms, the Postal Service should allow mailers to pay postage 14-30 days after mailing, subject to revenue protection safeguards.

### **POSTAL SERVICE COSTS MUST BE CONTROLLED**

- At a minimum, arbitration rules should be changed to reflect the fact that the USPS must meet competition and cannot simply pass through all costs.
- Both postal wages and benefits should be subject to negotiation.
- Employee compensation should focus more on performance and incentives.
- The Postal Service should control costs and automate wisely.



## **INTRODUCTION**

The Postal Service is the heart of the \$900 billion mailing industry. Nearly 9 million workers service our Nation's need for a hard copy delivery system. Our customers require reliable delivery service and well designed products, and market-based rates that are set in a way to encourage competition. If right choices are made this year, the industry has tremendous growth potential, growth that will benefit not only the Postal Service and our industry but can help drive the U.S. economy as well.

Some of the “right choices” to make the Postal Service more viable that ADVO hopes this Commission will recommend are:

- Enhance the value of the postal enterprise and preserve universal service.
- Create a stronger/more balanced balance sheet.
- Develop and execute a competitive pricing strategy.
- Offer modern, competitive payment terms.
- Reform the cost structure to be comparable with private sector competitors.

## **WHO WE ARE**

ADVO, one of the Postal Service's important partners with annual revenues of \$1.1 billion, is the largest direct mail marketing company in the world. Our postage payments represent half of our revenue and nearly 1% of the USPS' total revenue. We firmly believe we have the potential to triple our business within the next five years.

ADVO specializes in mailing pre-printed advertising circulars for retailers, product manufacturers, merchants, service providers, and professionals. Our more than 25,000 customers cover the spectrum from national retail chains to 20,000 small businesses. Their transactions with us range from less than \$500 to more than \$60 million per year.

Our mail volume consists of two components: (1) Solo mail, where ADVO mails a single advertising circular on behalf of a customer who pays the postage cost directly; and (2) Shared mail, where ADVO combines many customers' advertisements into a single mail package. In the latter case, we bear the risk of covering the postage costs, maintain a nationwide sales effort, establish a weekly network, and, because it is necessary for over 80% of our revenue, provide customers with flexible payment terms.

Solo mail has become increasingly less competitive with other media alternatives. Shared mail, by competitive necessity, has become the largest part of our business, representing more than 90 percent of our total mail volume and revenues. Our future in the retail mail preprint market rests on the ability of our shared mail programs to compete with media alternatives. Direct mail is the second largest advertising medium in the United States, having achieved that position in 2001.

Today, direct mail has the potential to become number one – or to lose market share as competitiveness erodes. Growth will require a healthy, market-driven hard-copy delivery system.

ADVO has 23 mail processing facilities and 50 sales offices nationwide. Our shared mail programs reach 65 million U.S. households weekly and over 100 million households monthly. Our customers distribute more than 29 billion pieces, which represents less than 2% percent of the home delivered print advertising business in the United States.

ADVO launched the America's Looking For Its Missing Children® program in partnership with the National Center for Missing & Exploited Children and the Postal Service in 1985. Our missing child cards are responsible for safely recovering 122 children.

### **RETAIL MAIL**

"Retail Mail" is printed advertising circulars distributed through the Postal Service. The basic tenet of the retail business is "mass merchandising" -- selling a variety of products with mass consumer appeal. Retailing is a low margin business, and our clients need to generate high frequency sales volumes. The best way to do that is to bring many people into the stores. Because retailers are mass merchandising hundreds, or even thousands of products, their basic advertising medium is print advertising (preprints).

"Preprints" permit retailers to display many products at the lowest advertising cost per item. The use of preprint circulars by retailers has grown dramatically from 1 billion pieces in 1960 to more than 100 billion pieces today. These inserts are distributed seven days a week, 52 weeks a year, and are principally carried by newspapers and private carrier delivery services. Mail has a relatively low share of these inserts. Because of the retail industry's low profit margins, retailers will use the mail only if it is cost-competitive with other delivery methods. Although ADVO is the largest mailer of insert material, we estimate that our revenue accounts for just 7% of the total annual insert revenue in the country.

Advertisers have many media choices; they and we are increasingly delivering preprints to the home through partnerships with newspapers or via private carrier delivery. ADVO alone distributes 240

million pieces annually outside the USPS, representing seven percent of our total shared mail volume. This represents a weekly revenue loss to the USPS of over \$500,000 or an annual loss of more than \$25 million. Despite the overall advertising recession that caused advertising spending to contract two percent from 2000 to 2002, direct mail revenue was up 1.4%, one of only two mediums to garner more of advertisers' budgets during this period. We are positioned to grow our business significantly, and if necessary we are prepared to grow outside the Postal Service. The Commission has the opportunity to make recommendations that will allow the Postal Service to be partners in our growth to our mutual benefit.

### **THE NEED FOR CHANGE**

The challenges facing the Postal Service are enormous and unprecedented. Mail volume declined 4.6 billion pieces in FY2002 compared to 2001, significantly eclipsing two previous declines. In 1975, during one of the worst recessions in history, mail volume declined by one billion pieces, but quickly recovered. In 1991, also a recession year, there was a 450 million-piece decline. In every other year since postal reorganization in 1971, mail volume has increased. To date this fiscal year, total mail volume (excluding Standard Mail) is down 2.2 percent. Standard mail volume, on the other hand, is up 6.6 percent from last year's levels even as the overall economy continues to languish. This is why we know there is opportunity to grow the mail in the future provided that postal costs can be managed down and that postal rates for competitive products can be kept stable and affordable.

For the third year in a row, the Postal Service reported a net loss in FY2002. Yet income from operations was positive in each of those years. In fact, the USPS has had positive income from operations in every year since 1990. Even in bad times, the Postal Service was able to more than

cover its operating costs. The USPS lost money in eight of the years between 1990 to 2002, principally because of government transfer costs such as the interest payment on the unfunded retirement liability (now recognized by the GAO, OPM and others as being overfunded). While the “death spiral” that some are predicting for the Postal Service could happen, it is not inevitable. The Postal Service’s basic operating model of delivering hardcopy, printed materials to homes and businesses is economically sound and, importantly, capable of supporting substantial growth provided that its liabilities and costs can be restructured to ensure affordable postal rates.

### **ENHANCE THE VALUE OF THE POSTAL ENTERPRISE**

While there are legitimate issues in defining the universal service “obligation”, the Commission should also consider the commercial value that could potentially be realized by a national network that has access to every American home and business six days per week. If universal service is reduced as a cost saving measure, the Postal Service’s viability will be weakened. The Postal Service is of value to the mail industry because it delivers our advertising messages to every home six days a week without charge to the recipient. We know that Americans read or scan their mail every day, making it an incredibly powerful communications medium. The Commission should reject any steps that would weaken the relationship between the American people and their mail. To the contrary, the Commission should recommend techniques that would strengthen that bond, e.g., the timing and frequency of daily delivery and the expansion of delivery to seven days. Five percent of ADVO’s packages are delivered on Saturday (none on Sunday). We estimate that over 60% of insert material is delivered on the weekend primarily via newspapers and other delivery options.

The Postal Service's marketability is enhanced by the police powers vested in the Postal Inspection Service to protect the safety and security of the mail. While events in the fall of 2001 may have temporarily shaken people's trust in their mail, ADVO's independent research of consumer readership demonstrates that their trust has never wavered and is in fact stronger now than at any time since we began that research.

### **STRENGTHEN THE BALANCE SHEET**

The Postal Service must have a strong balance sheet to properly reorganize. This should have been ensured when the Service was created 30 years ago. However, its September 30, 2002 balance sheet reported a \$30 billion deferred retirement liability. The Office of Personnel Management, the General Accounting Office, and the Treasury agree that this liability is actually much smaller due to the charges assessed by the Treasury. They also agree that the amounts paid by the Postal Service over the past 20 years have actually resulted in the Postal Service greatly overfunding its retirement obligations. On the other hand, obligations for post-retirement health care are not reported on the balance sheet while a \$6 billion reported liability associated with workers' compensation is. To ensure viability, the true extent of these liabilities must be calculated and properly funded. Past mistakes or miscalculations must not penalize the future operating results for the business going forward.

The Postal Service should not be required to cover through rates those costs imposed by Congress that private sector companies do not incur. Costs resulting from the Service's status as a government agency should be covered by the U.S. Treasury. This will put the Postal Service in a

position, going forward, to deal with those issues in the same way other businesses deal with them – in a way that is fair to employees but which allows it to become commercially viable.

Today's mailers can cover the cost of delivering today's mail – including a retirement benefit package for current postal employees – and remain competitive. What today's mailers cannot afford to do is cover costs imposed on the Postal Service that are not related to delivering today's mail.

The Postal Service should be moved to GAAP accounting, and retirement benefits (including health care) should be accrued each year to cover the current year's workers. The Postal Service's customers cannot afford and should not be required to pay for liabilities created by policy decisions made in the past. Recently proposed legislation regarding the Civil Service Retirement System (CSRS) liability is a major step in the right direction, but all liabilities need to be addressed in a way that is fair to postal customers.

### **DEVELOP A COMPETITIVE PRICING STRATEGY**

The Postal Service needs pricing flexibility and a competitive pricing strategy. The Consumer Price Index rose just 2.4% in 2002 despite a 10.7% increase in energy costs. The costs of many business products and services have been stable or have even declined in recent years. Our company receives significant discounts for many of the products we buy, and similarly, our customers look to us for discounts. Because the advertising business is competitive and our customers have choices, they have price leverage. We have similar price leverage with many of our vendors, but not with our most important vendor -- the United States Postal Service.

The Postal Service doesn't think of itself as selling a service that can be "resold," but ADVO and other saturation mailers are resellers of Postal Services, and even more, market makers and sales forces for the USPS. In most industries, wholesalers get the best prices because they pay costs (such as sales and marketing) that would otherwise be paid by the producer. Additionally, wholesalers typically have contractual relations that encourage business growth, producing stronger business results and outlook for both parties. Finally, the wholesaler is taking an entrepreneurial risk that the producer's product will sell. ADVO and other saturation mailers play that role for the Postal Service. Our marketing and sales force are out selling the Postal Service every day. When we open up a new territory or increase delivery frequency we often do so initially at a loss, as we build a market to profitability. A pricing strategy that provides resellers with incentives to grow business would benefit the Postal Service and those mailers.

The Postal Service also needs to rebalance its priorities to give marketing and sales an equal voice with operations. It needs more freedom to set rates according to market and demand conditions, particularly for its more competitive services. It should be free to negotiate volume discount contracts and / or performance rebates with mailers when the result will increase the bottom line.

The Postal Service's need for greater pricing flexibility is critical. Under the current statute, the Postal Service must go through a complex ten-month proceeding before the Postal Rate Commission before it can change rates. Its competitors are among the most active participants, urging higher rates for products with which they compete. The proceedings themselves are complex, exploring in excruciating detail every imaginable aspect of postal revenues, costs, and operations. No other business in America must wait that long to adjust its rates, or go through such an entangling,

unpredictable process, only to see the majority or the entirety of its proposed rates, in the end be amended and set by an outside regulatory body.

### **OFFER MODERN PAYMENT TERMS**

The Postal Service requires that postage be paid at the time of mailing. This is done in the name of “protecting the revenue,” but the prepayment requirement drives business away. Our competitors for preprint distribution routinely give advertisers 14, 30, or even 60 days to pay. The Postal Service does not even give us a few hours. This has led to a complicated and costly audit trail of estimated postage payments followed by debits and credits. As a result, we often require our customers to prepay based on our estimated postage costs. Our standard terms are prepayment which makes us less competitive. Once the final accounting is done we must send out second bills seeking additional payment or providing a credit. This “double-billing” is confusing and irritating. We are forced to provide credit terms to our (and therefore the Postal Service’s) largest customers at a significant additional cost to ADVO. Giving reliable customers the ability to pay after the mailing would make the Postal Service more user-friendly. Sending a bill for services rendered has been a common business practice for decades for businesses of all sorts around the world.

## CONTROL COSTS

The Postal Service must contain its costs in order to move from a cost-plus pricing system to one more oriented to the market. We applaud the efforts of Postmaster General Potter to keep expenses in line and we wish him continued success.

There is a limit, however, to what he can do without changes in the law, particularly with regard to labor costs, 79 percent of total costs. The USPS needs more freedom to manage its labor and other resources appropriately. Specifically, the binding arbitration provision should be amended. At a minimum, arbitration rules should be changed to reflect the fact that the USPS must meet competition and cannot simply pass through all costs. Both wages and benefits should be up for negotiation. Employees should be rewarded for performance and should be given incentives to improve. A more flexible workforce able to change jobs or perform a variety of tasks will keep the Postal Service viable even if volume continues to fall. Greater flexibility in work rules will allow the workforce to expand and shrink (if necessary) through attrition instead of through more disruptive downsizing.

Mailers have assisted the USPS with cost savings through worksharing. ADVVO has been a leader advocating carrier route, saturation, walk sequence, drop ship and sub-class discounts. The Postal Service intends to increase cost savings by applying its letter automation experience to flat mail. Technological innovations can enhance efficiency, but automation is not the solution for every type of mail. Automation for automation's sake may drive financially rewarding business away from the Postal Service or any business. ADVVO's core product, the shared mail package, which is drop shipped at our expense to the destination delivery office is a case in point. Our package is open on

three sides, making it easy for our clients' customers to access its contents and to achieve its primary role of consumer readership. Our mail covers virtually every residential address, is sorted in walk sequence, and we ship the vast majority directly to the delivery unit. We provide the Postal Service with regular, predictable, high volume mail that makes a substantial contribution to USPS fixed costs. Yet our product may not fit into the increasingly automated postal environment. While we do not expect the Commission to resolve this uncertainty, we would caution against any recommendation that would see technology investment alone as a universal solution to cost containment.

### **FOCUS ON THE CORE BUSINESS**

The Postal Service is in business to deliver hard copy to homes and businesses. Not only is this a viable business, there is untapped potential and opportunities for tremendous growth even with all of the recent changes in communications and the increasingly competitive environment. The Postal Service should be discouraged from seeking opportunities far afield from its core business. While ongoing innovation, investments, and development of new products and services is essential to success in the modern economy, the postal service should not try to become something it is not – such as an internet service provider or a clothing retailer.

Again, we applaud your commitment to a viable Postal Service. ADVVO shares that commitment and is ready to assist the Commission in any way we can.