ABM-T-1

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

POSTAL RATE AND FEE CHANGES, 2000	Docket No. R2000-1

DIRECT TESTIMONY
OF
WILLIAM A. MORROW
ON BEHALF OF
AMERICAN BUSINESS MEDIA
ALLIANCE OF NONPROFIT MAILERS
COALITION OF RELIGIOUS PRESS ASSOCIATIONS
DOW JONES & CO., INC.
MAGAZINE PUBLISHERS OF AMERICA
NATIONAL NEWSPAPER ASSOCIATION
THE McGRAW-HILL COMPANIES, INC.
TIME WARNER, INC.

DIRECT TESTIMONY OF
WILLIAM A. MORROW
ON BEHALF OF
PUBLISHING INTERVENORS

My name is William A. Morrow, and I am Executive Vice President/Operations of Crain Communications Inc. My testimony is being presented on behalf of the American Business Media (formerly American Business Press), the Alliance of Nonprofit Mailers, the Coalition of Religious Press Associations, Dow Jones & Company, Inc., the Magazine Publishers of America, the McGraw-Hill Companies, Inc., the National Newspaper Association and Time Warner, Inc.

Founded in 1916 as a periodical publisher, Crain Communications has grown into a multi-media corporation, although the core of our business continues to be the publication of periodicals, primarily intended for the business-to-business market. Among our better known titles are *Advertising Age, Automotive News, Autoweek* and Crain's regional business publications, such as *Crain's New York Business, Crain's Cleveland Business,* and *Crain's Chicago Business.* But, in addition, we also publish lesser known titles such as *American Drycleaner* and *Tire Business,* which have much lower distribution and lesser frequency, but are just as important to the decision makers in those respective industries served as are our larger periodicals. As I will discuss in greater detail below, the periodicals that we produce are typical of the business-to-business category, with circulations ranging from 6,000 to about 95,000 for our business-to-business titles. (Our largest circulation title is a consumer magazine.)

I joined Crain in 1985 as Senior Vice President. Prior to that time I was partner in charge of the Detroit region of Touche Ross & Co., now known as Deloitte and Touche. I started my career in Touche Ross' audit department while earning a bachelor of science in accounting from the University of Detroit, which I received in 1968. I also received a J.D. from Wayne State University Law School in 1971. I was elected a partner in 1978, and a partner in charge in 1983, and I had client responsibilities in many industries, including publishing. I am currently licensed as a Certified Public Accountant and as an attorney in the State of Michigan.

Based upon my education and training, my responsibilities at Crain include, among other things, all financial matters. Although we are still considered a small publisher, we have nevertheless implemented sophisticated financial budgeting models and financial analysis disciplines since I have joined Crain. We now have a financial services department of forty individuals, including five CPAs. We conduct business planning meetings with our publishers each fall, and these meetings include a detailed analysis and forecast, by month, of each item of income and expense in their upcoming budget. We close our monthly financial statements within ten days of month's end, and immediately prepare a detailed memorandum analyzing the reasons for all variances, and what impact these variances are expected to have for the balance of the year.

My testimony in this proceeding will serve two purposes. First I will describe the impact of the proposed increase in periodicals rates on the type of small-circulation periodicals published by Crain, by other members of American Business Media and by smaller-circulation periodical publishers in general. Second, I will address the 2.5% contingency provision requested by the Postal Service in this case and will show that, based upon the unique circumstances here, it would be appropriate to eliminate any contingency allowance in the costs attributed to periodicals.

I recognize that the Postal Service has claimed in its rate filing that the average increase for regular rate periodicals will be around 12.7%, but the increase that will be experienced by Crain Communications and, as I understand it, magazine publishers of all types and sizes will actually result in a postage rate increase of around 15%. I have attached to my testimony a chart (Attachment 1) showing the 20 domestic periodicals published by the main division of Crain Communications in which I provide the mailed circulation, the frequency of publication, the weight of the publication, an indication of whether or not we drop ship any significant portion of the copies, a statement of whether the circulation is regional or national in scope, and the dollar effect of the proposed postage increase on each of our periodicals. As shown there, the increases range from 11.55% for our tiny (circulation 6,000) periodical weighing only .056 pounds to a high of 16.97% for a weekly publication weighing approximately 4 ounces with a circulation of 65,000. The weighted average increase in postage costs for Crain would be 14.76%, or an increase of $1,649,283 annually. I have also attached a chart (Attachment 2) prepared by a relatively large ABM member, Cahners, showing the impact of the proposed increase on 45 of its publications. As shown there, nearly all of the increases are very close to 15%, and they average 14.62%.

An increase of this magnitude in one of our major cost components would be difficult to handle at any time, but it is especially difficult at a time of low inflation when those entities that provide our revenues – whether advertisers or subscribers – have become unaccustomed to the kinds of price increases that would be necessary to recoup this increase in postage costs. In addition, of course, to the extent that we publish "requestor" publications, we have only a single source of increased revenues – our advertisers – and it is well known that the competition for advertising dollars has become far more intense with the explosion of the Internet.

Crain Communications is a successful company, and it is not my testimony that this postage increase, if approved, would be financially ruinous. But it is my testimony that an increase of this magnitude will have a significant impact upon our operations and, perhaps most tellingly, could stifle the development of new periodical products that will benefit not only Crain but also the Postal Service and the nation's business community. The business-to-business press serves a major role in the development of this nation's commerce. Anything that interferes with the normal development of periodicals to serve new or growing businesses, including postage increases out of line with inflation, can cause damage well beyond the loss to the bottom line of the publisher.

One unique but fully justifiable way to moderate the rate increase for periodicals is to eliminate any contingency allowance in the costs attributed and assigned to periodicals. I understand that in the history of postal ratemaking under the Postal Reorganization Act, it has never before even been suggested that the contingency allowance be viewed on anything other than a systemwide basis, but based upon my accounting background and my admittedly limited review of the postal ratemaking process and decisions, I see no reason why the past must be blindly adhered to in this case. In fact, from an accounting standpoint, it seems to me that it makes far more sense to view a contingency allowance or its functional equivalent on a product-by-product rather than on a corporate basis.

Let me give you an example. If Crain Communications is considering the purchase of periodical titles from other publishers, we of course must perform a rather detailed due diligence analysis of the profitability and potential for profitability of any titles considered. If that analysis were to include a contingency for forecast errors, it would be foolish for me to use the same percentage contingency irrespective of the factual situation pertaining to each individual title. For example, if one of the titles under consideration has been published for forty years, has a very stable subscriber base, is the number one periodical in its field and has a steady history of advertising revenue growth, I cannot conceive of dealing with a contingency in that situation in the same manner as I would when considering a publication that had been in existence for only a year or two and that had advertising revenues that varied widely during that short period of time. Similarly, if there is good reason to believe that the possibility of forecast errors may well be significantly different for different postal products, there is no reason that I know of why the same contingency factor need be applied to every class and subclass of mail. USPS witness Tayman could cite no authority, other than past Commission decisions, for the proposition that the contingency must be across the board (Tr. 325), and he testified that he knows of no study supporting the theory that a contingency should be the same across all product lines (Tr. 327).

I repeat my understanding that what I am proposing has never been proposed before, much less approved. But that doesn't make it wrong. And I recognize that, under normal circumstances, it may well be inefficient for both the Postal Service and the Postal Rate Commission to consider a separate contingency allowance for every subclass of mail, given the very nature of the contingency and its purpose in attempting to offset the effects of incorrect estimates, the source of which is unknown. Nevertheless, I submit, the situation facing periodicals in this case justifies, at least for this case, a departure from prior practice, given both the proposed increase of more than twice the average increase (coming on the heels of a series of large increases) and given the situation, described below, in which there is an all-out effort to reduce periodical costs by the test year.

Certainly, there is very recent precedent for taking a fresh look at a contingency based upon unique circumstances. In R94-1, the Postal Rate Commission itself referred in its decision (at page II-12) to Postal Service Witness Porras's statement that in that case the Postal Service was willing to live with a much smaller contingency than it "would normally find prudent." The Commission added (at page II-13) that the size of the increase facing mailers was one factor that was considered in reducing the contingency from that which would otherwise be sought. Here, of course, the increase for most mailers is much smaller, but that certainly does not mean that periodicals mailers facing a 15%

increase should be faced with an excessive contingency merely because other mailers are facing more moderate increases.

Before continuing, I should stress a couple of points. First, I am not addressing the overall level of contingency that should be afforded to the Postal Service in this case. On the contrary, as my testimony will show, whatever contingency is found to be justified for other classes of mail, no contingency is justifiable for periodicals. I understand that Lawrence Buc will be providing testimony sponsored by many parties (including ABM) to the effect that the 2.5% contingency allowance requested is excessive and should be reduced. Second, it is not my testimony that the mere size of the increase or the hardship that it will impose upon periodical mailers alone justifies elimination of the contingency. Rather, as I will later explain, there are unique factual circumstances in this case concerning cost reduction efforts that justify the elimination of the contingency allowance on the basis of evidence that is or will be in the record.

Before I turn to that specific justification, however, it is important to address the nature and purpose of a contingency allowance and some of the prior rulings with respect thereto. I do not profess to be an expert in postal ratemaking, but I do believe that my accounting background as well as my review of the relevant portions of a series of Postal Rate Commission opinions and other documents related to the contingency allowance provide me with sufficient knowledge to address this topic. One of the more cogent explanations for the contingency allowance is found in the Commission's decision in R77-1 at page 29, where it stated: "The contingency allowance is a recognized provision designed to offset the effects of misestimates in the test year relating to revenue and costs." The Commission added that it typically looks at historic variances and projected economic conditions. Similarly, in its R76-1 opinion at pages 51-52, the Commission stated that "the essential purpose of a contingency provision is to prevent a working capital shortage due to a revenue shortfall or to expenses which are unforeseeable in kind or amount." In that docket, the Commission added (at page 57): "We must also take into account, in this connection, the ability of the Postal Service to absorb the consequences of erroneous predictions of costs and revenues."

While, typically, one would consider a contingency allowance to be a positive number and to reflect the risk of costs that had not been forecast, the Commission has made clear that the development of an appropriate contingency allowance requires consideration of both favorable and adverse errors. In its Recommended Decision in Docket R84-1 at page 28, it stated: "If the Postal Service intended this statement to indicate that the development of a contingency provision should consider only adverse effects, then we must disagree. Even Postal Service Witness Lee conceded during oral cross-examination that he had considered both favorable and unfavorable events which might occur." This point is very important in this docket, because as I will explain later, the primary basis for my recommendation is that there are likely to be unanticipated or at least uncalculated periodical cost reductions in the test year that at least offset unanticipated cost increases.

I have not performed any type of "variance analysis" with respect to periodicals costs, or any other postal costs, in large part because in my view the situation facing periodicals and periodicals costs in this case is unique. But I do recognize that the Commission has in the past, such as in Docket R80-1 at page 21, found variance analysis to be a "sound" tool although not one to be relied upon to the exclusion of other factors. On the other hand, I understand that the Postal Service has typically opposed the use of variance analysis, claiming, for example, in Docket R84-1 (see Recommended Decision at 12) that basing a contingency allowance upon prior performance has "no statistical support whatsoever" but that "the determination of the size of the contingency remains an inherently judgmental one." The Postal Service expressed similar views in Docket R87-1, where it claimed that variance analysis is "superficial" (see Recommended Decision at page 26), and in this case Postal Service Witness Tayman (T-9 at page 45) reiterates opposition to any significant consideration of variance allowance. For these reasons, as well as for the perhaps more important reason that periodical costs are, we hope, at the dawn of a new era, I do not believe that analysis of the variance between estimated and actual periodical costs in past years provides useful guidance here. Based upon its consistent position, the Postal Service should agree.

My final point before turning to the specifics of this case involves the Commission's authority to do what I am asking. I understand that the 1981 decision of the United States Court of Appeals for the Second Circuit in *Newsweek, Inc. v. United States Postal Service,* 663 F.2d 1186 (2d Cir. 1981), may have circumscribed the Commission's authority to make major changes in the requested contingency allowance, but the Commission, at least, does not believe that its authority has been totally emasculated. Thus, the Commission found in Docket R84-1 (at 25):

> Accordingly, we have concluded that the Commission has both the authority and the responsibility to make adjustments in the Postal Service's proposed revenue requirement, so long as our adjustments are not arbitrary, our reasoning is fully articulated and based upon substantial evidence in the record, and where our adjustments have neither the intent nor the effect of causing more frequent rate filings nor constitute an intrusion into the policymaking domain on the Board in accordance with the holding in *Newsweek.* [footnote omitted]

Here, I submit, the adjustment of the periodical contingency to zero would not be arbitrary, would be based upon substantial evidence of record and, given the fact that periodicals contribute only 3% of Postal Service revenues, will have a truly *de minimis* effect upon overall Postal Service revenues, will certainly not affect the timing of future rate filings and cannot possibly constitute an intrusion into the policymaking domain of the Postal Service Board of Governors. Accordingly, I submit, if the Commission agrees with me that there is no need for a contingency allowance for periodicals in this docket, the Commission, at least, appears to believe that it has the authority to implement this proposal.

With that background, it is time to explain why, based upon the probably unique factual circumstances of this case, it is appropriate to reduce the periodicals contingency to zero. As the Commission is well aware, and as is detailed yet again in the testimony of other publisher witnesses, periodical costs as calculated by the Postal Service have in recent years risen beyond the ability of anyone to provide a cogent and compelling explanation. As a result, the Commission took the unprecedented step in Docket R97-1 of virtually eliminating the contribution of the periodicals class to institutional costs. Around the same time, in an effort to determine why periodical costs appear to have increased so rapidly and to reverse that trend, the Postal Service and the periodicals industry created the Periodical Operations Review Team that intensively toured postal facilities throughout the country to examine carefully the ways in which periodicals were being handled by the Postal Service. The report of that review team has been well publicized, and some of its fifteen general areas of recommendations have been or are being implemented by both mailers and the Postal Service, as explained in the testimony of Jim O'Brien.

It is my understanding that the creation of the review team, the implementation of its recommendations and the implementation of other cost-cutting measures is a matter of extraordinarily high priority at the Postal Service. The Postmaster General has himself spoken several times about the need to stem the periodical cost trend, and he has pledged to do so. I understand that some of the results of this high-level effort, such as, for example, increased utilization of flat sorting machines for periodicals, have made their way into the Postal Service forecasts that are part of its rate filing in this case, and that is a step in the right direction. I also understand that, as promised by the Postmaster General and other executives within the Postal Service, the Postal Service has throughout this case cooperated with publisher interests in providing additional data to support further, "on the fly" adjustments that, although not part of the original filing, might well obtain Postal Service acquiescence as the case moves forward. Again, this is yet another step in the right direction.

But these steps are not enough. Magazine Publishers of America Senior Vice President Rita Cohen will be offering testimony that details many of the further test year cost reductions that mailer and Postal Service efforts support, but those adjustments can be made only where the specific dollar effects of specific initiatives can be identified with sufficient precision to permit such a test year adjustment. Those changes that are at this point unquantifiable or deemed too speculative for quantification have not been included by the Postal Service in its roll forward or by the publisher intervenors in their cost adjustment proposals.

However, merely because these further cost reductions cannot now be accurately quantified does not mean that they should be ignored, just as unquantifiable and unidentifiable test year cost increases are not ignored but are routinely considered in the form of a contingency allowance for the Postal Service.

The appropriate treatment for such likely but difficult to identify cost reductions is to consider them as part of the contingency allowance. As I stated earlier, the Commission had made clear that both favorable and adverse possibilities should be taken into account in determining the appropriate contingency level.

Once again, I am not a postal operations expert so I must rely upon Ms. Cohen's testimony for an identification of those areas where test year cost savings that we cannot quantify are likely to occur. Of course, if we could assign dollars to those efforts we would be proposing still further reductions to the test-year cost of service rather than an adjustment to the contingency. We certainly hope that with the full support of the Postmaster General and other members of the Postal Service's top management, and with the cooperation of the mailers, the actual test year costs will be reduced beyond those reductions already identified by well more than the proposed 2.5% contingency (or whatever lesser contingency the Commission might establish for the remainder of the classes). In fact, retention of the 2.5% contingency is tantamount to a finding that the strenuous efforts of mailers, top postal management and postal field personnel to implement cost reduction changes will be a total failure. I think it is fair to assume that these efforts will succeed, and therefore, my initial temptation would be to recommend a negative contingency, but I have settled for the more pragmatic zero contingency approach.

Periodical mailers face a crisis, a crisis that postal management itself recognizes and is committed to avoid. We must assume that this massive commitment will not go for naught but that, over the next several months, changes in the way that periodical and other flat mail is prepared, presented and processed will, at long last, reduce the inexplicable upward trend in periodical handling costs. Under these circumstances, I submit, it is not only appropriate but necessary to offset whatever unknown cost increases contribute to the need for a contingency allowance by the more certain cost reductions that will result from these admirable Postal Service efforts. The result should be a zero contingency allowance for periodicals, a *de minimis* revenue reduction for the Postal Service but a significant reduction in the rate increase faced by magazine publishers.

CRAIN COMMUNICATIONS INC.
PROPOSED POSTAL RATE INCREASE
ANALYSIS

USPS CIRC	FREQUENCY	WEIGHT	DROP SHIP	REGIONAL/ NATIONAL	2000 BUDGET	2001 PROPOSED	ANNUAL INCREASE	% INCREASE
6,000	Bi-Weekly	0.056	N	N	$34,420	$38,396	$3,976	**11.55%**
20,000	Bi-Weekly	0.238	N	N	$121,572	$137,471	$15,899	**13.08%**
25,000	Weekly	0.281	N	R	$145,303	$163,095	$17,792	**12.24%**
25,000	Monthly	0.48	N	N	$68,554	$77,748	$9,194	**13.41%**
25,000	Weekly	0.343	Y	N	$279,197	$321,517	$42,320	**15.16%**
25,000	Bi-Weekly	0.253	Y	N	$155,900	$175,184	$19,284	**12.37%**
35,000	Monthly	0.394	N	N	$109,180	$125,958	$16,778	**15.37%**
40,000	Weekly	0.651	Y	N	$567,080	$653,031	$85,951	**15.16%**
40,000	Weekly	0.315	Y	N	$427,244	$492,295	$65,051	**15.23%**
40,000	Weekly	0.377	Y	R	$366,047	$415,860	$49,813	**13.61%**
45,000	Weekly	0.383	Y	N	$556,297	$639,861	$83,564	**15.02%**
45,000	Weekly	0.219	Y	N	$446,593	$514,767	$68,174	**15.27%**
50,000	Bi-Weekly	0.288	Y	N	$257,211	$295,435	$38,224	**14.86%**
55,000	Weekly	0.427	N	R	$402,101	$454,342	$52,241	**12.99%**
55,000	Bi-Weekly	0.427	Y	N	$296,273	$340,539	$44,266	**14.94%**
65,000	Weekly	0.511	Y	N	$904,150	$1,045,200	$141,050	**15.60%**
65,000	Weekly	0.228	Y	N	$590,158	$690,313	$100,155	**16.97%**
65,000	Weekly	0.37	Y	R	$507,000	$567,408	$60,408	**11.91%**
65,000	Weekly	0.319	Y	N	$731,709	$852,017	$120,308	**16.44%**
95,000	Weekly	0.288	Y	N	$834,309	$957,857	$123,548	**14.81%**
325,000	Weekly	0.265	Y	N	$3,371,152	$3,862,439	$491,287	**14.57%**

TOTALS:					**$11,171,450**	**$12,820,733**	**$1,649,283**	**14.76%**

***This analysis is based upon a representative issue of each publication**

Attachment 1

CAHNERS BUSINESS INFORMATION

PROPOSED POSTAL RATE INCREASE

This report shows the impact of the proposed rate increase on a sampling of representative Cahners publications.

USPS Circulation	National/ Regional	Freq.	Drop Ship	Entry Points	class	2000 Annual Cost	Annual Increase	Est. 2001 Annual Cost	Percent Increase
1,000	National	Monthly	N	1	P	$4,952	$513	$5,465	10.36%
6,000	Regional	Daily	Y	2	P	$369,165	$56,291	$425,456	15.25%
8,000	National	Daily	Y	44	P	$300,314	$41,211	$341,525	13.72%
9,000	National	Weekly	Y	3	P	$105,000	$15,000	$120,000	14.29%
10,000	National	Monthly	N	1	P	$41,800	$5,500	$47,300	13.16%
13,000	National	Monthly	N	1	P	$43,200	$6,000	$49,200	13.89%
13,000	Regional	Daily	Y	40	IC*	$490,389	$63,301	$553,690	12.91%
14,000	National	29/yr.	Y	8	P	$213,925	$30,966	$244,891	14.48%
15,000	National	Weekly	Y	37	P	$221,588	$33,853	$255,441	15.28%
16,000	National	Bi-month.	Y	12	P	$76,259	$11,886	$88,145	15.59%
19,000	National	Weekly	Y	40	P	$251,268	$38,616	$289,884	15.37%
20,000	National	Bi-month.	N	1	P	$142,247	$21,770	$164,017	15.30%
22,000	National	Weekly	Y	8	P	$315,000	$50,000	$365,000	15.87%
22,000	National	Monthly	N	1	P	$80,400	$12,000	$92,400	14.93%
24,000	National	Weekly	Y	37	P	$272,962	$41,936	$314,898	15.36%
24,000	National	Monthly	Y	2	P	$115,200	$16,800	$132,000	14.58%
25,000	National	Monthly	N	1	P	$75,230	$10,695	$85,924	14.22%
27,000	National	Weekly	Y	10	P	$333,789	$51,666	$385,455	15.48%
27,000	National	Monthy	N	1	P	$151,632	$22,955	$174,587	15.14%
27,000	National	Monthly	N	1	P	$198,000	$28,800	$226,800	14.55%
28,000	National	Monthly	N	1	P	$8,077	$1,195	$9,272	14.80%
36,000	National	Weekly	Y	8	P	$391,090	$50,807	$441,897	12.99%
38,000	National	Weekly	Y	40	P	$431,261	$61,567	$492,828	14.28%
40,000	National	Monthly	N	1	P	$10,832	$1,557	$12,389	14.37%
41,000	National	Monthly	N	1	P	$117,600	$18,000	$135,600	15.31%
41,000	National	18/yr.	N	1	P	$10,145	$1,479	$11,624	14.58%
43,000	National	Weekly	Y	40	P	$474,371	$69,416	$543,786	14.63%
43,000	National	Monthly	N	1	P	$298,500	$43,500	$342,000	14.57%
46,000	National	Bi-month.	N	1	P	$99,000	$15,000	$114,000	15.15%
47,000	National	Weekly	Y	38	P	$525,300	$81,600	$606,900	15.53%
47,000	National	16/yr.	N	1	P	$12,939	$1,913	$14,852	14.78%
51,000	National	Bi-Month.	N	1	P	$14,802	$2,173	$16,975	14.68%
55,000	National	Semi-Wk.	Y	44	P	$1,535,190	$219,500	$1,754,690	14.30%
72,000	National	Monthly	N	1	P	$324,000	$49,200	$373,200	15.19%
75,000	National	Monthly	N	1	P	$20,438	$3,014	$23,452	14.75%
78,000	National	Monthly	Y	D.E.**	P	$373,100	$55,900	$429,000	14.98%
78,000	National	Monthly	N	1	P	$21,894	$3,246	$25,140	14.83%
85,000	National	Monthly	N	1	P	$22,814	$3,385	$26,199	14.84%
92,000	National	Monthly	N	1	P	$21,800	$3,197	$24,997	14.67%
108,000	National	Monthly	N	1	P	$25,873	$3,745	$29,618	14.47%
117,000	National	Monthly	N	1	P	$30,865	$4,503	$35,368	14.59%
135,000	National	Semi-mnth.	N	1	P	$32,470	$4,723	$37,193	14.55%
150,000	National	Monthly	N	1	P	$37,423	$5,462	$42,885	14.60%
187,000	National	Semi-mnth.	N	1	P	$41,698	$6,075	$47,773	14.57%
199,000	National	Monthly	N	1	P	$48,717	$7,119	$55,836	14.61%
2,274,000						$8,732,519	$1,277,035	$10,009,554	14.62%

* IC - In-county ** D.E. - Dynamic Entry - Number of entries varies per issue, depending upon weight, Ad%