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

POSTAL RATE AND FEE CHANGES, 2006 **DOCKET NO. R2006-1**

DIRECT TESTIMONY
OF CLIFTON B. KNIGHT, JR.
ON BEHALF OF
THE ASSOCIATION FOR POSTAL COMMERCE,
THE MAILING AND FULFILLMENT SERVICE ASSOCIATION AND
THE DIRECT MARKETING ASSOCIATION

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Direct Testimony

My name is Clifton B. Knight, Jr. I am Executive Vice President of Legal & Business Affairs at BMG Columbia House, Inc. BMG Columbia House is owned by Bertelsmann AG.

BMG Columbia House is the largest direct-to-consumer marketer of music and movies in the United States. We have over 14 million members in our music and movie clubs. Our music clubs offer 14,000 CD titles licensed from the four major music labels and from dozens of independents. Our video club offers 10,000 films based on licenses with most of the major studios and many of the independent film companies.

I. Autobiographical Sketch

I hold the following degrees: B.A. in Economics, North Carolina State University, 1970; J.D., University of North Carolina School of Law, 1974; and MBA, Strategic Planning, New York University, 1986. I have been employed by BMG Columbia House, Inc. and its predecessor companies since 1975, and I have been involved in government, legislative and postal matters for over thirty years. I am responsible for all of the company’s legal activities, product acquisition, manufacturing and purchasing, and inventory management. I have not previously testified before the Commission.

II. Purpose of Testimony

I am testifying on behalf of the Association of Postal Commerce, the Mailing and Fulfillment Service Association, and the Direct Marketing Association. The purpose of my testimony is to address the extraordinary impact that the Postal Service’s radical changes in rates and classification will have upon BMG Columbia House’s ability to continue to use the mail for the delivery of music and video products to our 14 million club members. I will show that the rates and classification changes the Postal Service has advanced with respect to the so-called Non-Flat Machinable category and the punitive rate increases imposed on Standard Mail Parcels and Media Services will make it impossible for my company to remain in the business of selling music and video products by mail. I will further show that, if we are constrained to stop using the mail for product shipments, we will inevitably discontinue our use of the mail for marketing and promotional purposes.

The Postal Service's approach to the "problem" – if there really is one – of automation in this case is not only arbitrary and unconscionable, it is economically irrational and reckless: these rate and classification changes the Postal Service has advanced will put in jeopardy the business model that my company has pursued for over 50 years and will deprive the Postal Service of the more than $100 million a year that we spend on postage.

BMG Columbia House has worked diligently to ensure that our packages meet the Postal Service's preexisting specifications. Nevertheless, the Postal Service seems to have ignored these efforts in this rate case. One could suspect that the Postal Service's zeal to modify its customers' products to fit its future operations is self-defeating. A wiser choice for the Postal Service would be to adapt its operations to fit the existing and traditional specifications of its customers' products, or, at the very least, to give some consideration to what has worked up until the present time. The Postal Service does neither in this rate case.

In Part III of my testimony, I describe how BMG Columbia House's business operates. In Part IV I discuss how BMG Columbia House uses the Postal Service for its product shipments. Finally, in Part V, I demonstrate the dramatic impact the Postal Service's proposals will have on BMG Columbia House.

III. How the Music Club Business Operates

A brief summary of the evolution of the music and video club business and how our clubs operate will put my testimony in context.

A. Our History

BMG Columbia House is the successor to two major direct marketing companies with long, distinguished histories. In July of 2005, BMG Direct acquired Columbia House. Over the course of the past year, we have integrated the two companies into the new company, BMG Columbia House.

Columbia House was founded by Columbia Records in the early 1950's. It quickly became the leading distributor of music through the mail. In 1986, Columbia House launched the first video club modeled after its music club. In 1997, Columbia House launched its DVD club. The DVD format and Columbia House's DVD club business have thrived.

Following Columbia Records' entry into the record club market in the early 1950's, RCA Records responded by launching the RCA Victor Great Music Society, later branded the RCA Victor Music Club, with an emphasis on classical recordings. As RCA grew and expanded its offerings, the name of the business was changed to RCA Music Service. Bertelsmann acquired RCA Records and RCA Music Service from General Electric in 1986, shortly after GE had acquired the entire RCA Corporation. RCA Music Service became part of the Bertelsmann Music Group (as did RCA Records). BMG Direct music club brands include BMG Music Service, BMG Classical

Music Service, the BMG Jazz Club, Ritmo & Pasión (Latin) and Sound & Spirit (Christian).

Following BMG Direct's acquisition of Columbia House in 2005 and the formation of BMG Columbia House, the company's music business is operated under the BMG brands. The company's DVD business operates under the Columbia House brand.

B. How We Do Business

The business model that BMG Columbia House follows is, in its fundamentals, unchanged since the founding of the first music club over 50 years ago. In combination, our music and video clubs have 14,000,000 members. Approximately 18 times each year, we mail members a "catalog" identifying the main selection in the club to which they belong for that cycle. The catalog also offers the opportunity to purchase additional or different selections from the clubs and provides an opportunity for those club members who do not wish to purchase during that cycle the opportunity to decline to do so. We mail approximately 46 million music and video shipments to our client members each year made up of more than 82 million CD units and more than 54 million DVD units.

The life blood of BMG Columbia House's clubs is new member enrollments. Without new members, the clubs will atrophy. We use a variety of marketing channels to recruit new members and win back consumers who have allowed their memberships in our clubs to expire. The channel decisional process is proprietary, but, in its fundamentals, very similar to that used by Bookspan as described by witness Epp in Docket MC-2005-3.[1] Determining which marketing campaigns actually get executed

[1] I should note that Bookspan is a sister company with BMG Columbia House, Inc. in the sense that it is partially owned by Bertelsmann.

and what channels get used is a complex multi-factor decision analysis. Particularly in application to direct mail, the process is carried out by evaluating candidate mailing lists under a standard set of business metrics. We determine the expected profitability for each candidate campaign list in question. Changes in costs – such as dramatic changes in postage – profoundly affect the marketing channel process: lists that were profitable cease to be so and are dropped.

The marketing channel selection process is inextricably connected to the cost of delivering our CDs and DVDs to our club members. If the cost of delivering our product through the mail goes up – especially at the staggering levels proposed by the Postal Service – we will have fewer customers to serve; fewer customers leads to fewer opportunities to enroll new members. It is a profound mistake to assume, as the Postal Service seems to, that the postage costs that we would incur under its proposals can simply be passed on to consumers through shipping and handling charges.

In the first place, there are practical, competitive limits on how much potential club members are willing to absorb in the way of shipping and handling charges. While BMG Columbia House is the leading operator of music and video clubs, we are not the only channel through which consumers can acquire these kinds of products. BMG Columbia House faces intense price competition from mass merchandisers such as Wal-Mart, large national specialty chains such as Best Buy and Circuit City, smaller regional and local retailers, and internet retailers (many of whom offer free shipping).

Secondly, and most importantly, the economic effect of drastic increases in our shipping and handling charges on our business is exactly the same, whether we increase our S&H charges or not. Under either scenario, the increase in postage costs associated with product shipment is going to lead to a reduction in the return on our investment in candidate lists that we might use to otherwise promote new membership and in fewer club members to be served. Moreover, in order to maintain economic stability in our business, we rank applicants based on expected profitability before accepting them into one or more of our clubs. Higher costs mean that we will reject more members with the same results – fewer members means less mail.

I will explain the full effects of the Postal Service's proposals upon our company and the Postal Service itself in the concluding section of this testimony. For present purposes, the fundamental point I wish to make is:

- The Postal Service naively assumes that companies like BMG Columbia House will either pass on the increases in rates proposed in the Non-Flat Machinable, Standard Parcel categories and Media Services or will absorb those costs without any effect on the conduct of their businesses, and that our use of the mail will remain as it is today. This is totally unrealistic in all respects.

IV. Our Use of the Mail for Product Shipments

We mail approximately 46 million music and video shipments to our club members each year. Virtually 100% of the product shipments have, heretofore, been entered at Standard Mail or Media Services rates.[2] The following sets forth a breakout of the way in which we use the postal system for product delivery to our club members:

[2] We send a very tiny percentage of our product shipments at Priority Mail or Express Mail rates.

A. Automation Flats

Approximately 34% of our music and video shipments made by BMG Columbia House meet the definition, under current standards, of a flat. We present them as flats, they are entered as flats, and, as far as we know, they are handled by the Postal Service as flats. In particular, our CDs are less than .75 inches thick and all of them have at least one side that is equal to or less than 6 inches in length. Our DVDs are approximately one inch thick, and they currently qualify for the UFSM 1000 equipment. The Postal Service has not yet published its newly minted flats automation definitions. Thus, in the preparation of this testimony, we have had to assume that 100% of this volume will be required by the Postal Service to be entered as Non-Flat Machinables.

The average unit increase in postage costs for the delivery of these products at the Non-Flat Machinables rate would be approximately 97%.[3]

B. Standard Parcels

Approximately 46% of our music and video shipments have been entered into the postal system as Standard Regular Parcels. This category of our product shipments includes pieces that are greater than .75 inches thick and weigh on average 8.3 ounces in the case of CDs and 1.25 inches thick and weigh on average 9.1 ounces in the case of DVDs and other video products.

The problem posed by the Postal Service here is not the question of reclassification. The pieces exceed the dimensions of an automation flat. We are not seeking a broadening of that definition. Rather, the issue here is simply the result of the

[3] In making this forecast, we have assumed that we would continue to be required to presort these pieces in the same way that we do now, as flats. We do not now drop enter our automation flats because the presort incentives are inadequate. They are even less adequate under the proposed non-flats machinable rate proposal advanced by the Postal Service.

extraordinary increases in rates that the Postal Service proposes to apply to standard parcels. Further, since the Postal Service has not yet promulgated its implementing regulations, we do not know what the sortation requirements for this new rate structure.

We have assumed, perhaps too optimistically, that we will be able to qualify for the DBMC sortation discount the Postal Service has proposed. If we are wrong in this assumption, then the actual increase in our postage costs for these Standard Mail parcels will actually be higher than we projected. We do not now qualify these pieces for drop entry because the drop entry discounts are inadequate to offset the added cost of preparation and transportation. The discounts under the proposed rate schedule are equally inadequate.

We have estimated that the postage rate increase for Standard Mail products is 61%.

C. Media Mail

Approximately 19% of our product shipments weigh over a pound and are shipped at Media Mail rates. Because we are able to presort these shipments, our projected increase of 16.8% is slightly lower than the average increase computed by the Postal Service.

Nonetheless, we are paying more than we should for Media Mail shipments. Under the Postal Service's rate design, postage is calculated on the weight of the piece rounded up to the nearest whole pound. Thus, for example, a Media Mail shipment consisting of 5 CDs and weighing 1.3 pounds is charged as if it weighed 2 pounds. There is no incentive to drop enter Media Mail services because no drop entry discounts are provided.

The 16.8% increase that we have calculated comes on top of a greater than average increase in the last rate case and we estimate that our total postage bill over the past two years for Media Mail has increased by nearly 30%. This simply adds insult to the grievous injury that we now face with respect to the potential disqualification of our automation flats and the punitive increases in our Standard Mail shipments.

V. The Impact on BMG Columbia House and the Postal Service

We have attempted to assess the impact of the Postal Service's proposal on our business. We cannot fully forecast the total effect of these changes, but we have, to the best of our ability, applied our normal forecasting models to estimate the impact. The conclusions we have reached are alarming, to say the least. Unless the Commission rejects or at the very least, very profoundly mitigates the rates proposed by the Postal Service, we anticipate that our annual volume of product shipments would decline drastically.

This decline will occur whether we attempt to pass on the additional postage as a shipping and handling charge or absorb it. If we pass the cost on, there will be a direct and immediate decline in sales volume that is greater than the cost of the postage increases. If we elect to try to absorb the added costs, we will be unable to sustain reasonable profitability levels and will be forced to curtail our enrollment efforts.

Specifically, we calculate that, we will lose more than 800,000 club members every year. Because this process is cumulative, the impact will be compounded over subsequent years. The proposed new rates will portend disaster for our business. The more that our club membership atrophies, the more we will be forced to curtail our efforts to solicit new members, causing us, in turn, to experience a further reduction in product shipments. At some point in the not too distant future, the business of shipping music and video products by means of the Postal Service will no longer be sustainable. We will continue to explore alternative forms of music and video distribution, including digital distribution over the Internet.

This is not mere speculation. Our estimates are based upon careful calculations using our detailed forecasting models of the impact of the Postal Service's rate increases, including, most especially, the increases proposed for our product shipments on our budgeting and marketing efforts. In reaching these conclusions, we have re-calculated the profitability of a sampling of lists we target for direct mail to reflect the proposed increases in postage costs. Overall, we estimate that we would be forced to reduce our marketing efforts by 13%.

In addition, as I have explained, the higher postage costs will have an adverse effect on the profitability we realize from new club applicants. Employing the statistical models we regularly use to determine the acceptability of new club applicants, we have concluded that there will be a substantial increase in the number of customers we would be forced to decline to serve.

The combined effects of our projected loss of existing customers and the concomitant reduction in our marketing efforts form the basis for our conclusion that BMG Columbia House will lose over 800,000 new customers each year that will not be replaced if these proposals are permitted to stand.

The adverse impact of these proposals on the Postal Service itself, even in the short run, are almost as severe as they are upon BMG Columbia House. Using our current volumes, we estimate that the Postal Service expects to realize a $26 million revenue increase from the combination of the general rate increases in the mail subclasses we use and the drastic increases applicable to our proposed product shipments.

As I hope this testimony makes clear, that assumption is not merely naïve; it is simply wrong. In fact, by our calculations, the Postal Service will fall short of the projected, static revenue increase of $26.7 million by more than 50%; we estimate that, in product shipments alone, the Postal Service will fall short of its expected revenue by $13.9 million. The loss of volume from reallocation of marketing resources, reduced use of the Postal Service for marketing and promotion brings the total net revenue loss to $19.9 million.

In the long run, the Postal Service has put in jeopardy the whole of the $100 million we spend each year.