

UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners:

Dan G. Blair, Chairman;
Mark Acton, Vice Chairman;
Ruth Y. Goldway;
and Tony Hammond

Report on Universal Postal
Service and the Postal Monopoly

Docket No. PI2008-3

**TESTIMONY OF VICKI UPDIKE
ON BEHALF
OF THE MILES KIMBALL COMPANY
(June 5, 2008)**

Mr. Chairman and Commissioners, Miles Kimball Company (MKC) appreciates the opportunity to appear before the US Postal Regulatory Commission to discuss our position on the Universal Service Obligation and its impact on the catalog industry.

Summary:

The US Postal Service (USPS) is an important partner for the Miles Kimball Company (MKC). MKC cannot be successful without a strong postal national system. As such, issues which affect the USPS are issues we must be concerned with. How the Universal Service Obligation (USO) is defined exactly is of less concern for many catalog companies as the nature of our business provides us with flexibility on how the USO is met. However, as a postal rate payer, the significant compliance cost of the USO is an issue that impacts MKC and more generally, all catalogers, who currently provide a significant portion of the cost of running the system. With predicted declines on other mail categories, and demographic trends favoring catalogers, properly managed, the catalog class has the potential for continued volume growth in the future and with this, further contribution to the institutional costs of the USPS and the USO it supports.

Unfortunately, recent postage rate trends have put this opportunity in jeopardy. Catalogers are working aggressively to reduce their mail volumes, an impact which has only begun to be felt in USPS Standard Mail volumes. While we do offer some ideas to help address the revenue-cost gap that is propelling much of the discussion around the USO, we hope the USPS will do two specific things beyond any adjustments to universal service. First, we consider the fixed overhead cost of the system to be high and we offer some specific ideas to bring the total institutional cost down. Second, noting the growth potential in the catalog category, we seek an adjustment as to how catalogers are managed that will stimulate, and not depress, catalog mailing, creating significant additional volumes that can make any level of universal service more affordable. Finally, we discuss the value of catalogs in the mail and why catalogs help drive loyalty, interest and excitement that keeps mail welcome.

Impact of Catalogs in the US Mail

The catalog industry is diverse and highly fragmented. Estimates indicate there are nearly 20,000 distinct catalog companies with most companies doing less than \$10 million per year in revenues. While some of the larger catalog titles create a significant amount of volume, there are also many small companies who focus on distinct niches or market segments. Cataloging is a great way to address market segments that lack critical mass in a specific geography required for traditional retail stores. However, like retail, cataloging is a merchant based activity and is typically a low margin commercial endeavor. We are not aware of any definitive estimate of the volume of catalogs mailed each year but frequent estimates put the volume of catalogs mailed at around 20,000,000 pieces annually.

Our customers truly enjoy receiving catalogs. Catalogs provide interest and valued content in the mail that arrives daily. This helps keep mail a welcome addition to each home each day. Catalogs enhance the overall value of the mail and keep mail relevant to the recipient.

While, given the lack of authoritative information, reasonable people may differ on the exact number of catalogs mailed and the revenue or fixed cost absorption they generate, all must agree that catalogs provide a significant component of the total cost of meeting the Universal Service Obligation. Applying an estimate of \$0.29 cents per average catalog mailed to the volume above, catalogs contribute nearly \$6 billion in revenues and generate over \$2 billion to the institutional cost of running our nation's mail system.

Background on the Catalog Industry

The catalog industry has historically been highly reliant on the USPS. The USPS is effectively the sales force for catalog companies for order gathering and new customer generation. Catalogs have also been a growth category in the past decade when First Class mail volumes have been on the decline. Given this historic co-dependence, MKC realizes our success is tied to a strong national postal system.

To understand our perspective, it is necessary to provide a brief overview of the economics of cataloging. A typical consumer (B2C) cataloger spends a third of its revenues on marketing. Traditionally this has been the production and mailing cost of catalogs. Prior to the rapid change in postage rates due to R2006-1, about half this marketing cost was postage. The other half is made up of paper, production and a variety of other costs associated with putting the catalog together.

Like other forms of retail, profit margins are tight. Well run companies typically earn around 5% of sales. The low margin nature of the catalog industry requires careful management of the risks. To manage this risk, catalogers test new approaches in advance of large scale adoption. Testing a change against a known control allows catalogers to eliminate promising ideas for innovation that prove unworkable in reality, without putting the entire enterprise at risk from the quick adoption of an ill-considered idea. We expect this test-adjust-retest-implement approach will be useful for any changes considered to the USO. There are many unknowns in changing a system that has served America well for decades. Modifications to the USO may affect the value of mail for sender or recipient. For instance, how does consumer behavior change with decreasing delivery frequency? Does the time starved consumer find it easier to receive mail less often so they can spend concentrated time on the mail when it does arrive? Conversely, does less frequent delivery lead to mailbox clutter, causing the recipient to become overwhelmed with mail, leading to reduced impact, lower response rates and less value of mail to mailers?

As direct marketers, we would welcome the opportunity to test changes in the frequency of delivery to better understand how prospective changes to the USO affect mail's impact for both sender and recipient. We would be happy to participate in a controlled test environment where changes to consumer behavior could be monitored with changes to frequency of delivery. With

this 'testing' strategy, both the USPS and MKC could measure the impact before making sweeping changes.

The test-correct-implement approach of direct marketing also makes it important that any future change to the USO, or any other aspect of USPS operations for that matter, be made with significant advance notice and lead-time, giving mailers the maximum opportunity to adjust to changes so the net effect is beneficial across the entire mail system.

Impact of R2006-1

No discussion on the national postal system that involves catalogs can be had today without consideration to the fundamental change to the economies of mailing created by the R2006-1 rate increase. The magnitude of last year's cost increases combined with decreased consumer spending had a profound effect on many direct marketers. In just the first four months of 2008, many established catalogs went into bankruptcy: Paragon Gifts, Bits and Pieces, National Wildlife Direct, Winterthur (all known under the Blue Sky Brands banner), Lillian Vernon, Shaper Images, and Red Envelope. Other established catalogers like Flax Art & Design ceased direct operations all together and is now focusing entirely on retail operations. The catalog industry has had significant reductions in force through layoffs and hiring freezes. Public companies such as Coldwater Creek have revised earnings forecasts downward and others have failed to meet earnings expectations. Information not yet made public suggests there will be other high profile bankruptcy filings in the coming months.

Overall, the entire catalog industry has had a significant blow to its profitability. Catalogers, Miles Kimball Company included, are working actively to reduce their reliance on the US Mail because of their inability to offset increasing postage cost. Many mailings have simply become uneconomic.

A twenty to forty percent increase to a cost center that historically represented 15% to 20% of total revenues dramatically hurts the bottom line. Catalogers have had no choice but to make rapid adjustments to their mail volumes. Companies are still working to reduce these volumes further.

With the rates increasing, especially within Standard Mail, many direct marketing companies like Miles Kimball Company have had to make significant changes to marketing and circulation plans just to survive.

To put the issue in perspective, cutting Miles Kimball Company customer circulation by just 100,000 means \$27,000 less postage revenue to the postal service. There is an additional \$22,000 loss in revenue for the postal service because we have fewer orders to ship. As we have fewer orders and therefore fewer customers, our mail volume will go down in subsequent mailings. This is the “Multiplier Effect” working in reverse.

Beyond the direct losses, there is a secondary impact to this decreased circulation that impacts other existing catalog mailers. Catalog mailing lists are a major source of prospective customers to other businesses and organizations. When mailers cut circulation, there will be fewer potential customers on files to support those that survive. The primary cuts are compounded by secondary reductions when mail volume of other mailers who rely on the Miles Kimball Company buyer file in their own prospect efforts are impacted. Depending on the number of mailers affected and their corresponding response rate, the net loss to postal service may be many times that of the initial \$49,000 reduction from MKC. As declines in sales revenue take hold, other companies are forced to trim future circulation plans and redirect as much business “on line” as they can. The compounding reduction in catalog industry volumes will have significant impact to USPS revenues as well.

Miles Kimball Company mails approximately 138,000,000 catalogs per year. With only a 1% reduction in circulation, the USPS loses over \$676,200 in direct revenue and Miles Kimball Company loses 40,000 customers forever, continuing the downward spiral. The compounded secondary revenue loss is many times this.

Unlike other volume declines the USPS is experiencing, this structural migration away from mail is internally driven (that is, caused by factors wholly within the mailing industry) as opposed to externally driven by factors outside the direct control of the mailing industry (such as the greater use of the Internet for electronic bill presentment and payment). Since catalog volume represents nearly ten percent of the mail and provides billions of institutional cost coverage to help meet the USO, we believe it is in everyone’s interest that large scale migrations of catalog volume away from the mail not occur. Yet this is precisely where the industry is headed.

The impact is not only being felt by catalogers and their employees. The American mail recipient and the USPS are also feeling the impact. Due solely from bankruptcy filings already made public, there have been over 4,000,000 loyal consumers who purchased in the last twelve months from bankrupt catalogs that have been affected. Over 50,000,000 in catalog circulation, and more than 4,000,000 in package volume, have been lost per year.

R2006-1 Rate Mitigation Strategies Adopted by Catalogers

The trade magazines are now filled with articles on reducing mail volume, migrating more prospecting and order gathering activity to the web. E-commerce consulting companies are booming since R2006-1 became effective. While catalogers have aggressively moved to rate mitigation strategies such as co-mailing, co-palletization, and format changes, these have not been enough to ameliorate the massive increase that took effect last year. In fact, slim jims, a format once offered to replace the traditional flat catalog because of its ability to be mailed at lower automation letter rates is now slated to have its page count halved to meet proposed thickness and weight restrictions, effectively taking slim jims “off the table” as a catalog substitute.

The impact of R2006-1 was catastrophic. Catalogers’ entire Profit and Loss structure was changed and catalog postage cost – the single largest expenditure category for most catalogers and a top ten cost center for every cataloger – was put on an entirely different trajectory. For mailings in-home between June 2007 and December 2007, the postage rate increase resulted in an additional \$3,099,000 in postage cost to the Miles Kimball Company. This amount was equal to 7% of total budgeted catalog promotion spending of the same period and a significant portion of prior year’s profit!

To offset the sudden cost increase, MKC had to scale back or completely stop prospecting efforts resulting in a dramatically smaller buyer file size. As noted above, this affects the USPS in both direct and secondary ways in perpetuating a downward spiral volume. Prospecting, or looking for “new” customers are the lifeblood of the future. A new customer receives many pieces of additional mail from us and has a multi-year effect.

For the direct mail industry, the 12 months buyer file size is the standard in measuring the health of a brand. We lost 90,139 active buyers across the four MKC brands. It was 3% of the

total buyer file of Miles Kimball Company. Since this impact is compounding and cumulative, the effect over decades of even these small changes is dramatic. MKC is only a single example of a trend we know is occurring across the entire catalog industry. When these numbers are applied to the estimated 20,000,000 catalogs circulated each year, the impact on the ability to meet the Universal Service Obligation is tremendous.

There were many initiatives that Miles Kimball Company began to offset these excessive postal rate increases. Unfortunately, each of these initiatives has lowered the response rates of our direct mail pieces.

Tabs-Tabs were added to the Walter Drake general merchandise catalogs to minimize the rate increase impact by qualifying the mailing for the letter rate. The tabs were tested and proved to negatively impact response rate by 5%. This is a loss of over 58,000 customers per year!

Lower paper weight - We also had to lower our paper weight to minimize the USPS rate increases. However, we have noted in the past that lower paper weight results in lower response rate and therefore lower revenue, again leading to fewer mail pieces being entered into the USPS system.

Short notice on changes from USPS - Unlike the internet channel, catalog planning cycles require longer lead-times. Paper is purchased at least three months before a mail date. It takes another one to two months after the mailing is in-home before we have enough data to measure the test results accurately and make determinations on future circulation volumes. The amount of time R2006-1 gave us between the announcement and implementation did not allow us to test any changes before rolling them out. Little time was available to react, consider alternatives, and work to overcome the additional costs that must be offset with higher sales, response rates or expenditure offsets. It was often too late by the time we realized some of these cost saving tactics actually cost us more at the bottom line. The result was a panicked reduction in volumes that continue today.

Cost reduction activities, while important, are only a part of this equation. In the face of sharply escalating costs to access the national postal system, ways to further improve the value of mail must be considered. For catalog companies, this means “response rate” or the number of catalogs mailed compared to the number of orders received. For catalogers, response rate is the primary measure of effectiveness of mail. To the extent that response rates were improved

significantly, the massive rate hikes levied recently would be more tolerable to catalog business models.

Generally speaking, as postage rates increase, the volume of catalog and direct mail will decrease but this calculation must be made relative to the cost, effectiveness and availability of substitute channels for marketing. If these changes are incremental, made over time, and telegraphed in advance, methods can be found to pull costs from elsewhere, improve efficiencies, build response rates, boost gross profit and/or average order size, each of which allows a cataloger to maintain or build piece volume in the face of escalating postage costs. None of these occurred with the R2006-1 change and effects of this disruption are continuing.

Recommendations for the Future

We applaud the USPS work to reduce total system costs. We welcome postal format and process enhancements that will reduce waste or create higher efficiency. We are highly interested in ways to improve response rates and the value of mail. As a mailer, Miles Kimball Company is committed to participating in this work.

MKC (and we expect all catalogers) invest heavily into process and software enhancements. Vendors to the catalog industry do likewise. Each is designed to prepare catalogs to move efficiently through the mail system. Any change that reduces the total cost of delivering catalogs is important but this calculation must be made holistically across the entire supply chain including the USPS, mailers and mail preparers or suppliers because changes in one area can have unforeseen cost impacts in another. With the many changes to postal operations driven by PAEA compliance, flats automation or process improvement combined with the current impaired state of the industry, it is critical that change be deliberate, tested, telegraphed early and considered across the entire system.

We believe that any consideration of the Universal Service Obligation must include an analysis of the cost to provide the USO as well as a discussion on opportunities to reduce that cost. We note studies indicating that between 70% and 80% of the total USPS cost of operations is “fixed.” By most commercial standards this is high proportion of fixed costs. For several decades, industry has been working to reduce fixed costs whenever possible and make costs variable with volume or revenue. While we do not claim to be experts in postal logistics, some broad comparisons suggest there are opportunities to operate differently. The largest retailer in

the world has just over 4,000 US stores compared to 37,000 separate retail locations for the USPS. That same retailer operates a nation-wide system of delivery and logistics from slightly more than a hundred distribution centers while the USPS has several times this number of plants. Even owing to the higher degree of variability in inbound material the USPS must accept, a simplistic analysis indicates there is an opportunity to reduce the massive fixed costs of operating the USPS by reducing its network of retail stores and plants. While external political considerations have made this problematic for the USPS to accomplish in the past, at a time we are considering significant changes to the Universal Service Obligation, we feel the issue must be addressed. Absent a large gap between USPS revenues and costs, it is doubtful a discussion on the USO would be had. While the USPS seems to be doing a good job of managing down its variable costs with reductions in volume, the more stubborn fixed costs must also be aggressively managed.

Many of our recommendations for the future require a close partnership between mailers and the USPS. Unfortunately, the current structure makes it difficult to achieve an optimum partnership with catalogers. Our experience with vendor partnerships is that they require deep understanding on both sides and ongoing communications with decision makers. When evaluating suppliers, we expect them to learn a great deal about our business and work with us to solve problems or suggest improvement opportunities. Best in class vendors regularly bring us ideas that reduce cost, build revenues or both. In today's paradigm, as a postal customer, we must interface with a wide variety of departments depending on the USPS product or issue. We work with one group for Standard Mail flats pricing, another for flats automation issues, another for parcels and still another for mailing standards and mail piece design issues. The catalog business is highly complex and tightly integrated in both marketing and supply chain. It is difficult to expect all these different groups can become highly knowledgeable about the catalog business making true partnership elusive. Moreover, few USPS representatives can actually make a decision to do things differently. Ideas for innovation must progress up a long hierarchical chain that includes the USPS and sometimes its oversight bodies. The ultimate decision maker may be highly removed a detailed insight into our business. If the catalog segment is an important segment for a supplier, we would expect they have a catalog team that has a deep knowledge of the catalog business model, has access to the supplier's entire product base and capabilities, and who has the decision making authority to work closely with us to optimize and build our business together. Changing how the USPS works with catalogers (and vice versa) will help capitalize on the mutual opportunities.

The Value of Catalogs in the Mail

The Miles Kimball brand has been serving its customer since 1935. Walter Drake, our second largest title, just celebrated its 60th anniversary last year. Of the customers who purchase from these brands in 2007, 76% of them continue to buy, and 14% (394,000) of these repeat buyers have already purchased from us again in the first three months of 2008. One of the reasons our customers are loyal is the convenience we provide. In today's time starved world, catalogs are especially relevant. The increasing cost of gas is another driver to catalog growth. Our catalogs are able to reach customers who live in small communities where we are the only way for them to find what they need. They allow older customers who find it difficult to travel, to shop at home. Sometimes the catalog is the only way for them to find what they need. Properly managed, the catalog industry can be an important source of growth for the USPS that helps cover the USO.

Despite some accounts of cataloging in the popular press over the past six months, catalogers have a great story to tell. We provide a very important service, one that is enjoyed by millions of people. We have many written testimonials from Miles Kimball Company customers exclaiming the benefits of our brands and how they enjoy getting MKC brand catalogs.

In an increasingly crowded communications world, we believe the USPS must manage mail as a communications channel, encouraging the content recipients want to receive so mail stays relevant for all types of mail borne messages. Catalog companies are great content providers that drive the value of mail.

In closing, we truly understand that the USPS must get more efficient in the future. We recognize that costs are increasing but they must be manageable to allow a business like ours to exist in the mail. As a postal customer with significant growth potential, working with us to help grow our business will have a positive effect on USPS volumes and its ability to meet its Universal Service Obligations, regardless of how we decided to define it. It is fair to say the USPS and Catalog Industry share a common goal.

Despite that the catalog industry has not been particularly involved in postal policy in the past, catalog companies rely heavily on the USPS and its success. For our part, Miles Kimball Company is committed to an improved partnership with the USPS and greater participation in the postal policy debate. The fact that I am here before you today is a great start!

Again, thank you for your time today and for giving Miles Kimball Company an opportunity to present testimony. I'm happy to take any questions you may have.

