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

Annual Compliance Report **Docket No. ACR2009**

Initial Comments of the American Catalog Mailers Association

In accordance with Order 380, the Notice issued by the Postal Regulatory Commission (Commission or PRC) on January 5, 2010, soliciting public comment on the Postal Service's December 29, 2009, Annual Compliance Report (ACR) for Fiscal Year (FY) 2009, the American Catalog Mailers Association (ACMA) hereby submits the following Initial Comments:

1. The ACMA is a trade association of catalog companies and their key suppliers that use the mail to solicit orders or to gather new customers. While catalog flat-shaped mail volume has been down since, in 2006 there were an estimated 20 billion catalogs delivered by the US Postal Service (USPS). In addition, catalog companies also originate a substantial amount of postcard and letter-shaped mail both in First-Class Mail and Standard Mail, as well as a large number of packages sent via a variety of delivery services including the USPS. ACMA members are multi-channel merchants that may also operate retail stores, advertise in a variety of other media, operate extensive websites or aggressively pursue eCommerce activities. Despite the wide use of various media in their operations, catalogs sent through the mail remain currently the mainstay of cataloger marketing contact. The choice of media is directly related to its market effectiveness, a calculation that takes into account (a) the cost of that media and (b) the revenue generated via that media, often measured by response rate and order volume.

Postage paid to the USPS by catalog companies to mail catalogs and other advertising materials represents one of the highest distinct cost centers for catalogers. Postage cost often ranges between 15% and 20% of total sales for business to consumer (B2C) catalogers, and 5% to 12% of sales for business to business (B2B) catalogers; some members report that when in a growth mode postage cost as a percent of total net sales can exceed 30%[1]. Given the high proportion that postage represents to their total cost mix, the variable-cost nature of their business models, and the economics of circulation decision making, catalog companies are very sensitive to changes in postage rates[2].

Catalog companies are highly dependent on mail as it has historically been the foundation media for their business models[3]. While catalog companies are devoting a great deal of effort in attempts to change this, the quality of mail responses still remains high compared to those of other channels. Since catalogers rely heavily on the USPS and since postage spending is a very significant driver of catalog company profitability, postal cost increases resulting from the R2006-1 rate case has created widespread disarray by altering fundamentally the economics of catalog marketing. Increased costs associated with the implementation of R2006-1 has caused many catalogers to redeploy their marketing expenditures to de-emphasize mail in favor of other media substitutes, leading to a sharply decreased mail volume[4]. This effort is ongoing. As a result, many catalogers report strategic initiatives designed to reduce their dependence on mail by thirty and event thirty-five percent per year for the next five years. An interesting contrast to the intent of PAEA, non-ACMA catalogers often view postage costs as not subject to market forces, uncontrollable and unpredictable, and have historically little interest in engaging to understand how postal policy is formulated or can be addressed. It is simply easier to focus on alternatives. For these reasons, ACMA forecasts a continued reduction in

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[1] Based on ACMA interviews with members, 2007-8.
[2] ACMA has conducted numerous briefings with the Commission on this point during 2009.
[3] See, among others, the UPM North American Multichannel Marketing Report, 2007, page 15 or survey recent issues of catalog trade publications (such as Catalog Success or Multi-Channel Merchant).
[4] See item 2 below.

catalog-generated mail volume for the foreseeable future unless action is taken to change the *status quo*. The simple reality is that if market effectiveness of mail does not improve for catalogers, the use of mail will continue to decline at an increasing pace as catalogers perfect other contact strategies.

Compounding the impact of the R2006-1 rate case is a widespread recession with depressed consumer confidence and retail spending, combined also with a general lack of commercial credit availability necessary to finance the purchase of both inventory and postage prior to revenue realization. Both the recession and the commercial banking environment have also placed a significant strain on catalog mailers. In 2006, the catalog industry was estimated to have generated $270 billion in economic activity. Cataloging then represented nearly 2% of US Gross Domestic Product (GDP)[5] in an economy hungry for end consumer demand. In addition to the migration away from mail, the impact of sharply higher mailing costs combined with current economic conditions has translated into widespread catalog industry layoffs and downsizing, reduced industry equity values and stock prices, depressed sales multiples, changes in ownership control often at “fire-sale” prices, management turnover in both catalog companies and their suppliers, decisions to discontinue catalog operations altogether, and other symptoms of economic turmoil. It is important to note that, while the widespread recession exacerbated this trend, changes in cataloger mail use predated a weakening of general economic conditions or the dearth of commercial credit.

This widespread instability affects all companies. Catalogers may often rent or exchange names with other catalogers; thus, volume declines by one cataloger impacts the availability of potential customers to other catalogers. The entire industry (and postal volume) suffers when there is a general reduction in the number of names that can be mailed. This effect is noted in the sharp

[5] Based on ACMA estimates drawn from a variety of sources. This figure includes direct commercial activity including upstream and downstream economic value added suppliers and includes eCommerce revenues generated by catalog companies. It does not include retail sales from companies that may also publish a catalog or revenue from retailers that do not use catalogs as a key component of their marketing mix. For instance, the direct sales by cataloger Williams-Sonoma would be included but volume from Nordstrom, who may occasionally publish a catalog, is not included.

reductions of "12-month counts," or the number of names on each cataloger's house file that have ordered in the past year, the single greatest measure of catalog economic health. Since 12-month customers are the ones that receive virtually every mailing of a cataloger and are also the ones that are most desired by other catalogers to prospect, persistent declines in 12-month counts across the industry is a troubling signal of future volume erosion in this segment of the mailing industry.

Today, catalog executives continue to report the industry is on a persistent downward spiral. While general economic conditions may be expected to reverse and there are signs of improved consumer spending, comparative mail volumes may not improve considering the availability of substitute media choices and the relative high cost of mailing. Given the fundamental change to catalog mailing economics starting in 2007, without a change to how this segment of postal customers is managed, the outlook for catalog mail volumes is bleak even after assuming a return to better economic conditions. Unlike other mail that is impacted by external factors beyond the control of policy makers, many of the factors affecting catalog-originated mail volumes are within the control of the mailing industry and policy makers. In fact, had catalogs received their *pro rata* share of automation investment and policy attention in prior decades that other types of mail have received, other than depressed volumes caused by the recession, catalog volumes would *not* be in a downward spiral of declining volume today. The situation is reversible. Proper attention to this sector to address the issues outline herein will go a long way to keeping catalogs in the mail for generations.

2. Catalog postage and other costs <u>drive</u> catalog-originated mail volumes; catalogs are highly sensitive to changes in rates, either favorable or unfavorable. Unlike some other sectors, the catalog industry volume expands (i.e. spiral up) or contracts (i.e. spiral down) in mutually reinforcing loop. Expansion and contraction are due to a variety of factors with postage cost being one of the more important. Information ACMA is receiving on the expectations for mail volume is born out in flats volume trends found on the USPS Revenue, Pieces &

Weight (RPW) Reports where flat-shaped mail has dropped from 54 billon pieces in FY2005 to 39 billion for FY2009. Following significant volume drops in the two catalog dominated Standard Mail products in FY2008 (-23% for SM flats and -22% in CR flats), these service categories were down a further 22% and 18%, respectively, in FY2009.

As noted above, the significant migration of marketing expenditures away from mail created by the implementation of a new pricing regime in May 2007 can even be reversed with proper management of this customer segment by fully understanding the drivers to catalog mail use and the value-added role of mail for catalogers. Efforts such as last year's "Summer Sale" start to address the need for more innovation in attracting and retaining mail volume, but much more must be done to stem the volume losses from a customer group who has operated a mail-dependent business model for more than a hundred years.

Visibility of future rate changes is an important factor to allow catalogers to maintain mail volumes in the face of increasing rates. The R2006-1 rate change hit catalogers wholly by surprise; even after a period of nearly three years, they are still feeling the effect of this "rate shock." The lack of time to prepare and adjust business plans to accommodate such high cost increases did additional damage to cataloger profitability, supplier profitability, and catalog mail volumes. Given their long decision lead-times across complex integrated supply chains, and the need to test new approaches in advance of widespread adoption so to minimize risk of failure, visibility to proposed changes in rates or regulations that drive costs stimulate mailer confidence and avoid unnecessary cost.

Catalogers are highly sensitive to the total cost of reaching their audience and are able to calculate a breakeven for each mailing. In fact, given the known ordering pattern of customer lists, and the gross margin and order size expectations of the current offer, catalogers typically mail as deep into their house files (i.e. customer lists) as possible until breakeven is reached. To cite a simplistic example, best customers order more dollars and do so more frequently than marginal customers. Catalogers will typically mail first to all of their best customers in a mailing, then continue to work their way down a stratified

customer list until the expected gross margin dollars generated from that customer segment equals the total cost of reaching that segment. Total cost is the printing, paper and mailing cost of the catalog. As costs go up, the number of customers that can be profitably reached through the mail declines.

Prospect and reactivation activity is similarly allocated. A catalog company's cash flow, capital structure and growth aspirations usually dictate the amount of prospect investment that can be made in each period. These dollars are then allocated among media channels. The amount allocated to mail drives the amount of prospect mail volume included in each mail drop. Thus, the cost per prospect (of which postage is typically 35% to 50% of this total) drives the number of additional catalogs added to the house file catalog production order to send to prospects. In normal times, prospecting and reactivation (prospect activity to former customers who have stopped buying) can amount to as much as 60% of the total mailing, making prospecting activity a substantial portion of total catalog mail volume.

Prospect and reactivation mailing is a long-term investment by a cataloger in its the future. It seldom breaks even in a single mailing. Put another way, the cost of acquiring, or re-acquiring, a customer is not expected to be recouped from orders gathered in that the prospect mailing. A cataloger must look at the Lifetime Customer Value (LCV) to assess what the likely value of a prospect conversion or re-conversion will be over time. To restate the impact described above in another way, the number of new consumers or businesses a cataloger prospects in each mailing is a result of the amount of money they can afford to invest in growth, the expected LCV and the "total cost per book" to reach the audience. Since postage can be half of this cost per book, higher postage results in fewer prospect books mailed and fewer reactivation attempts in each mail drop. It also carries a high opportunity cost to the Postal Service. Once prospects are converted to buyers, they then receive nearly all subsequent mailings from that cataloger thus creating a significant multiple effect.

Amplifying the impact of media choice for prospecting to total cataloger mail volume is the reality that catalogers tend to return to that successful media

channel in all subsequent communications to customers. Customers who have demonstrated the propensity to respond to email when being prospected or reactivated will tend to get emails in subsequent order gathering activity. Those who respond to mail offers will tend to get future mailings through the postal network. Prospecting and reactivation activity are the harbingers of future mail volume.

As the Postal Service notes in its ACR filing, "in announcing this modest increase, [it] also considered alternatives that catalog mailers have to contact their customers." Good business practices would find ways to slow migration out of the mail. Prospecting and reactivation via mail is a strategic leverage point; the USPS can secure future mail volume by keeping mail *the* favored channel for prospecting and reactivation efforts, and thus for repeat customer contract efforts.

3. Carrier route and standard flats represent about one-third of standard mail revenues. Catalogs make up the majority of these service categories. Considering the impact catalog mail has on postal revenue, the reduction to catalog circulation has significantly depressed previously reliable revenue for the Postal Service. The financial implications for the mail system, however, are not the only important element involved. Catalog shoppers welcome catalogs and the arrival of the catalog in the daily mail delivery helps reinforce the relevancy and content value of mail. Catalogs drive what has been called "the Mail Moment" to help keep mail recipients interested and involved in the mail. If the recipient does not perceive what arrives in the mailbox as "life-enhancing," it becomes all too easy to ignore other mail arriving during the delivery. There are also a myriad of social benefits derived by catalog mailings[6] that have important cultural, economic, informational and social ramifications for America.

4. As catalog mail volumes have demonstrated since 2007, the long-term implications of rate decisions must be considered as the effects of substantive changes can continue well into the future. In fact, many long-term catalog industry observers cite the fundamental change to cataloging economics that

[6] See ACMA's "The Social Benefits of Catalogs" for a more complete treatment of this subject.

occurred in 2007 as creating an inflection in cataloger mail use. The situation is widespread and deep-seated so cannot be easily addressed by more focused efforts such as Negotiated Service Agreements (NSAs) or even temporary incentive plans such as the Summer Sale. We applaud the Postal Service for "consider[ing] the health of the industry and [a recognition to] pursue a long run approach to address this issue." We also understand that pricing is an enormously complicated endeavor that has far-reaching implications across an organization and its customer base. Businesses develop customer pricing approaches over years, utilizing a deep understanding of customer behavior and decision-making. Work to implement market-based pricing is relatively new for the USPS and presupposes a detailed understanding of each customer segment. Fortunately, with the creation of dedicated USPS personnel focused on the catalog segment, the USPS has begun to amass the customer knowledge required for effective pricing. We would encourage the continued support of pricing initiatives by the Commission and a realization that all the down-stream impacts must be considered. In the case of catalogs, and using the "Summer Sale" as an example, this includes the upswing in mailing across all USPS products of participating mailers not only during the sale event, but for succeeding years, as the three-month "sale" stimulated mail activity that can be expected to have a significant tail of additional mail in FY2010 and beyond.

CONCLUSION

The catalog industry remains imperiled today. For the foregoing reasons, and in consideration to the many benefits of catalogs to (a) the USPS, (b) mailers who do not want to see any substantial volume leave the system unnecessarily, and (c) to America generally which needs stronger consumer consumption to overcome a recessionary malaise, employment for its workers and wealth creation that generates its tax receipts, the catalog industry requires a fresh approach by postal decision makers. We are appreciative that this work is underway and cautiously hopeful that it can bear fruit in the near term. We urge

the Commission to continue to provide a regulatory environment that seeks to stimulate innovation and accelerated improvement, especially where so many additional benefits can be realized by both the Postal Service itself and a wide number of Americans.

Respectfully submitted,

American Catalog Mailers Assn., Inc.

By:

Hamilton Davison
Executive Director
PO Box 11173
Hauppauge, NY 11788-0941
401-529-8183

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