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

Docket No. R97-1

Postal Rate And Fee Changes, 1997

**JOINT REPLY BRIEF OF
ALLIANCE OF NONPROFIT MAILERS,
AMERICAN LIBRARY ASSOCIATION AND
COALITION OF RELIGIOUS PRESS ASSOCIATIONS
ON REVENUE REQUIREMENT**

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April 10, 1998

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The Alliance of Nonprofit Mailers ("ANM"), American Library Association ("ALA") and Coalition of Religious Press Associations ("CRPA") jointly submit this reply brief on the issue of the Postal Service's requirement. For the reasons stated here and in ANM's initial brief, ANM, ALA and CRPA believe that the rate changes proposed in this docket should be denied.

INTRODUCTION AND SUMMARY

The initial briefs of the Postal Service and its allies on the revenue requirement issue merely underscore the Postal Service's failure to show that it needs any rate increase at all. Chairman Gleiman posed the question squarely during the initial round of hearings: "why is it that all of a sudden the Postal Service is going to go in the dumper in the test year?" 9 Tr. 4574. If the Postal Service has an answer, it does not appear on the record.

The Postal Service's brief that it has no solution to the two gaping holes in its revenue requirement: (1) the extent to which the Service's recent embarrass-

ment of riches has wiped out the projected test year loss, and (2) the extent to which its recent and projected project expenditures—which collectively account for approximately *three-fourths* of the Service's total increase in test year accrued costs over Fiscal Year 1997—may be properly recognized in the test year rather than in future years. The true magnitude of these two key values is unknown and unknowable on the record.

Under the circumstances, the Commission has no lawful alternative to rejecting the proposed rate changes in their entirety. There is not enough information to recommend rates based a smaller revenue requirement, for the record does not disclose where the break-even point lies, let alone the appropriate coverage ratios for particular classes and subclasses at that break-even point. And rubber stamping the Postal Service's proposed revenue requirement, in the hope that the Service would defer implementation of the rate increases, would abdicate the Commission's independent duty under 39 U.S.C. § 3622 to recommend rates that comply with Sections 3621 and 3622.

ARGUMENT

I. THE POSTAL SERVICE'S PROPOSED REVENUE REQUIREMENT IS DEVOID OF SUPPORT IN THE RECORD.

A. The Postal Service's Actual Financial Performance Since The Beginning Of The Test Year Has Demolished The Financial Projections Underlying The Service's Rate Request.

As ANM and OCA noted in their initial briefs, events have completely overtaken the financial projects underlying the Postal Service's rate request. For Fiscal Year 1998, the test year in this case, the Postal Service has projected an

operating loss in the range of \$1.2 billion. Halfway through the test year, the Postal Service's actual earnings are approximately \$1.2 billion in the black. To achieve full-year losses as large as the Postal Service projects, it would have to hemorrhage over \$2 billion of red ink during the last half of the fiscal year—accounting periods in which the Postal Service's earnings projections have been wildly pessimistic in recent years. The likelihood that the Postal Service will suffer losses of this magnitude in the remainder of the test year has become vanishingly small. ANM Initial Br. 2-3; OCA Initial Br. (First Section). Indeed, even DMA concedes that “the Postal Service is likely to show a surplus for the test year under the existing rates.” DMA Br. 2.

The Postal Service's response to these issues has an air of unreality. The section of the Postal Service's brief devoted to the revenue requirement issue offers little more than glittering generalities. While long on allusions to “important future objectives” and “fundamental choices,” and exhortations about the Commission's “responsibilities as a partner with the Postal Service,” the brief offers no meaningful discussion—and virtually no mention—of the inconvenient facts that other participants and the Commission have brought to the Postal Service's attention. USPS Initial Br. at I-1 to I-9. Nor does the Service even mention the internal strategy memorandum that it tried to suppress (35 Tr. 18730). The Postal Service's conspicuous silence on these matters amounts to a virtual default.¹

¹ Perhaps the Postal Service's silence reflects a tactical decision to defer meaningful discussion of the facts until the Service's reply brief, when other participants will have no chance to respond. If so, the Commission should give any such sandbagged arguments the weight they deserve.

B. The Postal Service Has Allocated A Grossly Excessive Share Of Its Planned Project Expenditures To The Test Year.

ANM's initial brief identified a second and independent defect in the Postal Service's proposed revenue requirement. The Postal Service's projected losses are driven in large part by anticipated disbursements for capital investment programs during the last few months of the test year. Indeed, planned expenditures on special programs of this appear to account for *three-fourths* of the total increase in test year accrued costs over Fiscal Year 1997. See USPS-T-9 (Tayman) at Exh. USPS-9M (showing that "Other Programs" account for approximately 3/4 of total change in test year accrued costs over FY 1997); 9 Tr. 4403 (Tayman).

The share of these expenditures that will actually occur before the end of the test year is speculative. Moreover, expenditures of this kind cannot worsen the Postal Service's financial position during the test year. That the Postal Service's cost studies show to the contrary necessarily results from expensing amounts that should be capitalized and amortized, or assuming amortization periods that are shorter than the anticipated payoff periods of the investments. ANM Br. 3-6.

The Postal Service's brief essentially confirms these facts. Its description of its spending programs makes clear that are predominantly infrastructure or other capital investments with a payoff period that will extend over multiple years: "Call Centers," "Priority Mail Processing Centers," "Delivery Confirmation service," "the Point of Service cash register system," "Associate Office Infrastructure," "Year 2000 Software," and "automation." USPS Br. I-5 to I-6. In the Postal Service's own words, it is "investing" in an "aggressive capital program." *Id.*; accord, 9 Tr. 4553-54 (Tayman) (identifying projects that are clearly long-

lived capital investments such as point-of-service retail terminals, delivery confirmation system); 35 Tr. 18611 (Porras) (“generally most of them” will have multi-year payoff); *id.* at 18612-13 (Porras) (projects “are expected to have benefits of multiple years into the future”).

A fundamental policy of rate regulation, known as the matching principle, dictates that expenditures that are expected to produce benefits to the regulated firm or its ratepayers over a period longer than one year must be capitalized and amortized over the full period when the benefits are expected to occur. *See* ANM Initial Br. 6 n. 3 (citing cases). Recovering the expenditures as expenses in the year of incurrence, or amortizing them over an unduly short period, violates the matching principle. It also creates intertemporal or intergenerational discrimination, for it requires today’s customers to subsidize the cost of assets used to serve future customers. *See Shalala v. Guernsey Memorial Hospital*, 115 S.Ct. 1232, 1234-35, 1237-39 (1995); *NCNB Corp. v. United States*, 651 F.2d 942, 949 (4th Cir. 1981); *Simplification of the Depreciation Prescription Process*, 73 R.R.2d (Pike & Fischer) 1275, 1284-85 ¶ 46 (1993).

A simple example should illustrate this point. Consider a municipality in which the price of rental housing is subject to cost-of-service rate regulation. Assume that a landlord buys a rooming house for \$300,000, and that the house has a depreciation life of 40 years.² Should the municipal rent control board allow the landlord to recover the entire \$300,000 purchase price from the first year’s tenants? Of course not: the first year’s tenants would pay extortionate amounts of rent, and future tenants would receive a windfall. If the asset is expected to

² *Cf.* 9 Tr. 4427 (Tayman) (depreciation life for certain types of Postal Service real estate is 40 years).

provide housing to tenants for 40 years, and income to its owner for 40 years, the purchase price should be amortized over the same period.

The same result occurs in unregulated competitive markets. No landlord in a competitive housing market could recover the purchase price of the house from the first year's rent: if the landlord posted such prices, the house would go unrented.

The Postal Service has utterly failed to satisfy this standard. To do so, the Service would need to demonstrate that the period within it proposes to recover the cost of each new investment project is at least as long as the expected payoff period of the project. The Commission will search the Service's workpapers in vain for any such information. *See, e.g.*, 9 Tr. 4411-12 (Tayman). Indeed, the Postal Service's Controller, Richard Porras, conceded on cross-examination that USPS has expensed projects that "are expected to have benefits of multiple years into the future." 35 Tr. 18612-13 (Porras).

The Commission need not undertake elaborate calculations to confirm that the Postal Service's proposed recognition of expenditures is far too front-loaded to satisfy the matching principle. The Service contends that all of its spending projects are prudent in the sense that their expected payoff (in incremental revenue or customer demand, or incremental cost savings) over the life of the projects exceeds their expected costs. 35 Tr. 18619:17-18620:5 (Porras). *See also id.* at 18375: "This case here, it's an investment. It's not a waste of money. It's an investment."³ If the payoff of the Postal Service's investments is expected to

³ The Postal Service has to take this position. The Service is not entitled to recoup expenditures from ratepayers unless those expenditures are "honest, efficient, and economical." 39 U.S.C. § 3621. An expenditure is not efficient or economical unless its net present value is positive—i.e., the present value of its expected

exceed their cost over the expected lives of the assets, then the investments can show a negative payoff during the test year *only if the Postal Service recognizes too large a portion of the expenditures as costs in the test year.*

The Postal Service attempts to defend its radically accelerated cost recovery on the theory that the Service's accounting for its project expenditures follows Generally Accepted Accounting Principles ("GAAP"). See 35 Tr. 18609-11 (Porras); *id.* at 18621:22-23, 18642:13-17 (Porras). But that simply confirms the existence of the problem. GAAP typically allows recovery of expenditures over a period that is far shorter than permitted by regulatory principles. *Shalala v. Guernsey Memorial Hospital*, 115 S.Ct. at 1239; *Simplification of the Depreciation Prescription Process*, 73 R.R.2d (Pike & Fischer) at 1284 ¶ 46; Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards No. 71: Accounting for the Effects of Certain Types of Regulation ¶¶ 3, 4 (issued December 1982).

This divergence is unsurprising, for GAAP and price regulation address very different concerns. GAAP is a codification of financial accounting principles, which is concerned primarily with the protection of investors. The central tenet of financial accounting is "conservatism": where a choice exists, GAAP deliberately errs on the side of understating actual corporate earnings. *Shalala, supra*, 115 S.Ct. at 1239; *Simplification of the Depreciation Prescription Process*, 75 R.R.2d 1284-85 ¶ 46. Price regulation, by contrast, is aimed primarily at protecting ratepayers and the general public from exploitation of a regulated

benefits exceeds the present value of its expected costs. See Thomas E. Copeland and J. Fred Weston, *Financial Theory and Corporate Policy* 25-26, 28-29, (3d ed. 1988); Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance* 11-25 (4th ed. 1991).

firm's monopoly power. *Shalala, supra*, 115 S.Ct. at 1239. In this circumstance, "GAAP does not offer adequate protection for ratepayers." *Simplification of the Depreciation Prescription Process*, 75 R.R.2d 1284-85 ¶ 46. Hence, "a regulatory authority may order an enterprise to capitalize and amortize a cost that would be charged to income currently by an unregulated enterprise." 3 FASB, Accounting Standards: Current Text § Re6.114.

C. Other Grounds Offered For The Postal Service's Proposed Revenue Requirement Are Also Without Merit.

In their initial briefs, the Postal Service and several interveners ask the Commission to accept much or all of the proposed revenue requirement *even if that amount is overstated*. Their arguments do not withstand scrutiny.

(1) The Postal Service asserts repeatedly that failure to recommend the full revenue requirement proposed by the Commission would jeopardize the Postal Service's "financial goals and objectives." *See, e.g.*, USPS Br. at I-2 to I-7; 35 Tr. 18585-86 (Porrás). The record contains no evidence, however, that this is so.

There is no reason an inflated revenue requirement is necessary to undertake an "aggressive capital program" and "improve service and responsiveness to customers." USPS Br. at I-5 to I-6. If the programs are prudent and cost effective (as the Postal Service claims), their payoff should exceed their cost. If so, the Postal Service should be able to finance them through a combination of retained earnings and prudently managed borrowing.⁴

⁴ The Postal Service is \$8 billion below its long-term debt ceiling of \$15 billion. 35 Tr. 18613-14 (Porrás). After dodging the question repeatedly (35 Tr. 18621-

What the Postal Service really seeks in this case is not just break-even revenues, but a stream of profits lush enough to enable the Service to pay for long-term capital investments primarily (if not entirely) out of current earnings. Competitive markets, however, do not permit this luxury. Neither does the break-even requirement of 39 U.S.C. § 3621.

(2) DMA asks the Commission to acquiesce in a test year surplus lest the Postal Service propose bigger rate increases based on a more remote test year. DMA Br. 9-10. With all respect, DMA's circumspection is misplaced.

First, DMA's assumption that a later test year would entitle the Postal Service to higher rates is completely speculative. If there is any truth to the Service's glowing predictions about its "cost controls," "effective management," "mailer confidence and further . . . volume growth," the "benefits of classification reform" that are "beginning to take hold," and the benefits to "postal customers of every stripe" that purportedly will accrue from the Service's massive spending spree (USPS Br. I-4 & I-5), future test years should offer rates that are *lower* than rates based on projected conditions in Fiscal Year 1998. And if the Postal Service fails to follow through on these representations in its next rate request, we are confident that DMA will join other participants and the Commission in holding the Postal Service to its word.

In any event, the Commission's governing statute and regulations do not allow the Commission to give any weight to DMA's scenario. To implement 39

23), and being admonished by the Presiding Officer to give a responsive answer (*id.* at 18623-24), Mr. Porras could offer no evidence that USPS would be unable to finance its spending plans through additional borrowing (*id.* at 18624:5-6). Indeed, he had not even tried to find out the answer. *Id.* at 18624:8-17.

U.S.C. § 3621, the Commission has adopted regulations requiring that the break-even status of proposed rates be determined within the bounds of a specified test year. 39 C.F.R. § 3001.54(f)(2). The Postal Service exercised its discretion under Rule 54(f)(2) by proposing a test year based on Fiscal Year 1998. Failing to hold the Postal Service to the break-even requirement for the test year that *it proposed* would violate both 39 U.S.C. § 3621 and Rule 54(f)(2).⁵

(3) The Postal Service's claim that acquiescence in a test year surplus would confer "substantial benefits to postal customers" by maximizing "rate stability" (USPS Br. I-1 to I-2) has it backwards. While an inflated revenue requirement allows the Postal Service, all things being equal, to maintain any given set of rates in place for a longer time before falling into the red, the *magnitude* of each rate change is likely to be larger than when the break-even requirement is enforced. If "smaller, more predictable rate changes" are the goal (*id.* at I-2), the way to achieve it is by imposing a tighter ceiling on each set of rate increases. USPS's argument, carried to its logical conclusion, would justify abrogating the statutory break-even requirement entirely. If rate stability is defined as maximizing the interval between rate changes, without regard to the size of the

⁵ DMA's rejoinder that the statute leaves the Commission with "substantial discretion" in implementing the statutory break-even requirement (DMA Br. 3 n. 4) misses the point. The Commission has exercised its discretion by adopting Rule 54(f)(2). The Postal Service has exercised its discretion under Rule 54(f)(2) by adopting a Fiscal Year 1998 test year. To treat the test year at this point as a movable target would amount to retroactive rulemaking, a violation of *Georgetown University Hospital v. Bowen*, 109 S.Ct. 468 (1988)—even if (contrary to fact) the evidentiary record provided any basis for selecting a different test period.

change, the obvious prescription would be to set postal rates at their monopoly profit-maximizing level. With enough over recovery of costs, the new rates could stay in effect indefinitely.

II. THE ONLY LAWFUL REMEDY FOR THE POSTAL SERVICE'S FAILURE OF PROOF IS REJECTION OF THE ENTIRE RATE REQUEST.

A. The Commission Has An Independent Duty To Enforce The Break-Even Requirement of 39 U.S.C. § 3621.

As ANM and OCA noted in their initial briefs, the Postal Service bears the burden of demonstrating that its proposed rates satisfy the break even requirement of 39 U.S.C. § 3621. The Commission may not lawfully recommend rates unless the Postal Service satisfies this burden. ANM Initial Br. 2; OCA Initial Br. (First Section) at 2-4, 6-7.

The Postal Service, joined by AMMA *et al.*, suggests that enforcement of these provisions would “infringe[] upon management’s prerogative to determine financial policy,” 9 Tr. 4517 (Tayman), or become an illegitimate “exercise in power politics,” AMMA *et al.* Br. 3. Commission enforcement of the break-even requirement, however, is not merely permitted but required by Section 3622(b) of the Act, which imposes a positive duty upon the Commission to enforce the break-even requirement of § 3621 along with other substantive ratemaking standards of the Act. 39 U.S.C. § 3622(b) (the Commission “shall make a recommended decision . . . in accordance with the policies of this title”).⁶ The Postal Service’s

⁶ See also 39 U.S.C. § 3622(b)(3) (specifically directing the Commission to recommend rates in accordance with “the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that

insistence on a hands-off treatment of its revenue requirement would effectively read Section 3621 out of Section 3622(b), and read Section 3622(b) out of the Act.⁷ By the Postal Service's logic, the Commission could *never* second-guess USPS's proposed revenue requirement, for higher revenue levels by definition always permit more spending flexibility than lower revenue levels.

The Postal Service and AMMA also suggest that the modest size of many of the proposed rate increases excuses the Service from complying with the break-

class or type plus that portion of all costs of the Postal Service reasonable assignable to such class or type"). For all classes of mail and mail services in the aggregate, this requirement is equivalent to a directive that total revenues equal total costs—i.e., that the Postal Service break even.

⁷ The Postal Service, without saying so openly, appears to be relying on *Newsweek, Inc. v. USPS*, 663 F.2d 1186, 1203-06 (2d Cir. 1981), and *Time, Inc. v. USPS*, 685 F.2d 760, 767 (2d Cir. 1982). The notion that *Newsweek* and *Time* deprive the Commission of authority to review the Postal Service's proposed revenue requirement has become an urban myth of postal ratemaking. The actual holdings of those cases are much narrower. In *Newsweek*, the court held only that the Commission may not recommend rates which would result in a loss during the test year, make arbitrary and unsupported reductions in key components of the revenue requirement (e.g., the contingency), make adjustments to the revenue requirement based on extra-record information, or manipulate the revenue requirement to "stimulate more frequent rate filings" or "discipline" the Postal Service for a "delinquent" rate filing. 663 F.2d at 1203-05. The court clearly recognized that the Commission could adjust the revenue requirement if the Commission's action rested on reasoned findings and relevant statutory criteria. *See id.* at 1205 (directing the Commission, if it modified the revenue requirement on remand, to "subject its productivity adjustment rationale to the same hearing process as all other materials upon which it bases its recommend decisions," and "articulate its reasons for any modification of the schedule proposed by the Board"). *Time* was essentially in the same vein. None of circumstances that led the court to overturn the Commission's action in *Newsweek* and *Time* are at issue here.

even requirement. There's no "modest increase" exception, however, to the break-even requirement 39 U.S.C. § 3621. If inflation is relatively low, or productivity growth relatively high, even "modest" rate increases may violate the break-even requirement.

The willingness of some (but not all) intervenor to forgive the Postal Service's failure to satisfy the break-even requirement does not relieve the Commission from its duty to enforce it. *Cf. AMMA et al.* Initial Br. 3. That AMMA and other commercial mailer groups wish to avert their gaze from the issue is perfectly understandable: the Postal Service's proposed rate increases for the commercial mail classes are in the range of only 3-4 percent. If *AMMA et al.* choose to waive their right to challenge the USPS's failure of proof, that is their prerogative. But not all mailers are so fortunate. As the Commission is aware, many users of Standard (A) nonprofit mail face rate increases in the range of 15-18%. Library rate mailers face increases that are far, far higher. These mailers have *not* waived their right to challenge the Postal Service's failure of proof.

B. Adjusting The Postal Service's Proposed Revenue Requirement Is Not A Viable Alternative To Rejecting The Rate Request.

OCA has suggested that the Commission, in lieu of rejecting the Postal Service's rate request outright, recommend rate increases based on a smaller revenue requirement. This split-the-baby approach, while understandable, is unlawful.

First, the record is devoid of the evidence needed to determine the Postal Service's actual test year revenue requirement. As the Postal Service and *AMMA et al.* note in their opening briefs, the cost and revenue data available on the record

are too sparse to support more than limited adjustments to Postal Service figures. AMMA Br. 4-6; DMA Br. 4; 35 Tr. 18578:8-11 (USPS witness Porras). Most notably, there simply no way to patch the two giant holes in the hull of the Postal Service's rate case: the extent to which the Postal Service's recent financial upturn has wiped out its projected test year loss, and the share of the Postal Service's recent or forthcoming project expenditures are properly recognizable in the test year. The true magnitude of these two critical values is unknown and unquantifiable on the record. Any attempt to reduce the Postal Service's proposed revenue requirement to the break-even level would be sheer guesswork.

Second, the record also lacks evidence to justify the inter-class and inter-subclass rate relationships that would emerge from a smaller revenue requirement. As DMA notes, the integer constraint on First Class rates prevents the Commission from reducing the Postal Service's proposed rates *pro rata* with a reduced revenue requirement. Accordingly, adjusting the revenue requirement almost certainly would change the relative markups over attributable costs among the classes and subclasses. OCA's proposal to give all savings to First Class mail is only the most extreme manifestation of this phenomenon. *See* DMA Br. 3 n. 5 (history of past wild swings resulting from integer requirement).

The record is devoid of evidence showing that the institutional cost markups and coverage ratios resulting from OCA's proposal (or any other proposal based on a revenue requirement differing substantially from the Postal Service's proposal) would satisfy the criteria of § 3622(b). *See* AMMA *et al.* Initial Br. at 2-3, 6.

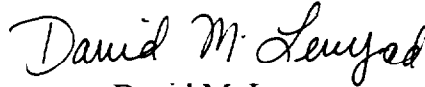
C. Abdicating Enforcement Of The Test Year Break-Even Requirement To The Governors Would Be Unlawful And Irresponsible.

AMMA *et al.* and DMA propose that the Commission, rather than enforce the break-even requirement, recommended inflated rates and then exhort the Service to delay implementing them. AMMA Br. 7-10; DMA Br. 9. The Commission should decline this invitation to abdicate its responsibilities. Sections 3621 and 3622 direct the Commission to recommend rates that comply with the break-even requirement of the statute. Empty admonitions to the Governors do not discharge the Commission's statutory obligation to protect captive ratepayers by provide an independent check on the Postal Service's rate proposals.

CONCLUSION

For the foregoing reasons, the Postal Service's proposed rate request should be denied in its entirety.

Respectfully submitted,



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April 10, 1998

CERTIFICATE OF SERVICE

I hereby certify that I have on this date served this document upon all participants of record in accordance with section 12 of the rules of practice.

David M. Leuzer

April 10, 1998