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REGULATORY UPDATE AND THE PRC'S ROLE IN REFORM

*ASSOCIATION OF ALTERNATE POSTAL SYSTEMS
THE VISION AND VOICE OF PRIVATE ADVERTISING DISTRIBUTION*

April 27, 2013

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Introduction



- Role of the Commission
- Recent Regulatory Activity
- Regulatory Issues Ahead
- Challenges in Current Environment, Reform
- Closing

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Role of the Commission



The Commission fulfills three key roles

- Ensure the Postal Service complies with the law
- Provides transparency and accountability of the Postal Service
- Advise the Service on changes in service that are at least substantially nationwide in effect

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Role of the Commission



- In fulfilling its statutory roles of determining compliance, fostering transparency and accountability, and advising on large scale service changes:
- Stakeholder participation is key

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Recent Regulatory Activity -ACD



- On March 28 the Commission issued its Annual Compliance Determination (ACD) discussing:
 - ▣ Overall financial condition of the Postal Service
 - ▣ Standard flats cost coverage/pricing
 - ▣ Non-profit worksharing discounts
 - ▣ Periodicals costing and service issues
 - ▣ First-Class Mail elasticity and pricing

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Recent Regulatory Activity -ACD

Findings – Financial Performance

- Financial Performance
 - ▣ \$15.9 billion loss in FY 2012
 - \$11.1 billion Retiree Health Benefit Fund expense
 - \$2.4 billion Workers' Compensation Liability expense
 - \$2.4 billion Loss Under Management Control
 - ▣ Sixteen workshare discounts exceeded costs
 - Directed to improve or explain in next rate adjustment

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Recent Regulatory Activity – ACD

Findings - Standard Flats

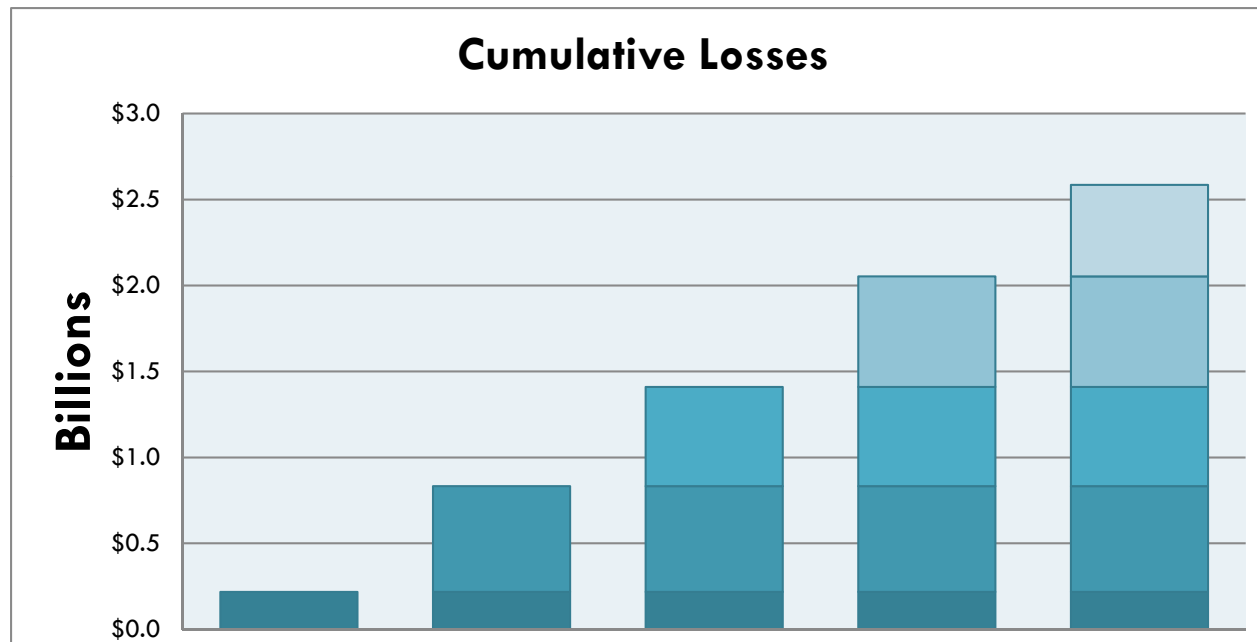
- In 2010 the Commission found that the prices in effect for Standard Mail Flats in FY 2010 did not comply with 39 U.S.C. 101(d).
 - ▣ Finding predicated on a series of previous regulatory concerns expressed in ACDs and annual rate adjustments
 - ▣ There was a significant (and growing) cost coverage shortfall that persisted over a significant period, there was evidence that the shortfall was likely to increase further, and the Postal Service had failed to address the shortfall or take remedial steps
- Culminated in a direction to the Postal Service to increase Standard Mail Flats cost coverage through a combination of above-average price adjustments and cost reductions

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Recent Regulatory Activity – ACD

Findings - Standard Flats

□ Standard Mail Flats Cost Coverage and Losses



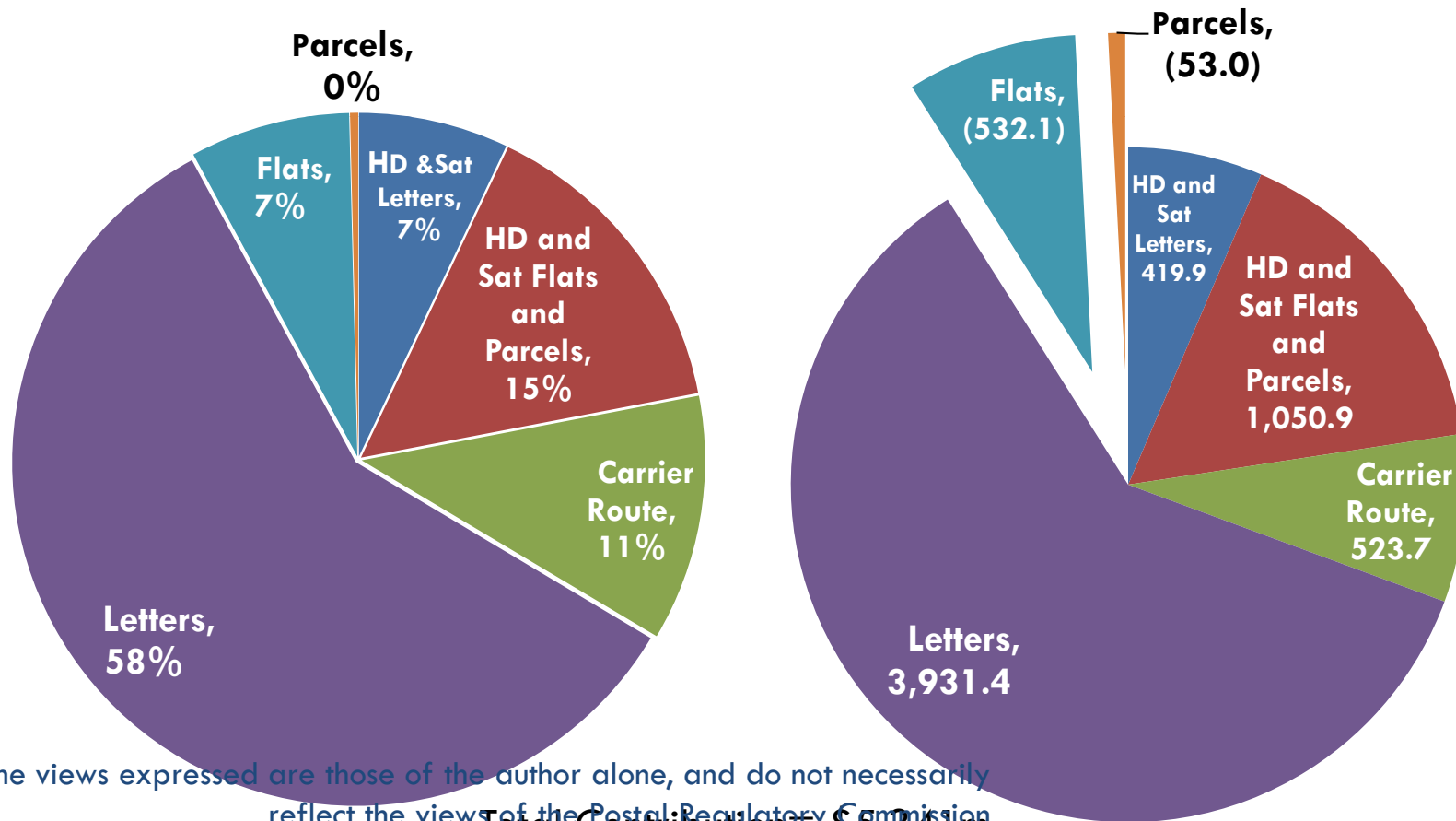
| FY | 2008 | 2009 | 2010 | 2011 | 2012 |
|---------------|-------|-------|-------|-------|-------|
| Cost Coverage | 94.4% | 82.4% | 81.8% | 79.5% | 80.7% |

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Recent Regulatory Activity – ACD

Findings - Standard Flats

- FY 2012 Std Mail Volume & Contribution (\$5.341 b)



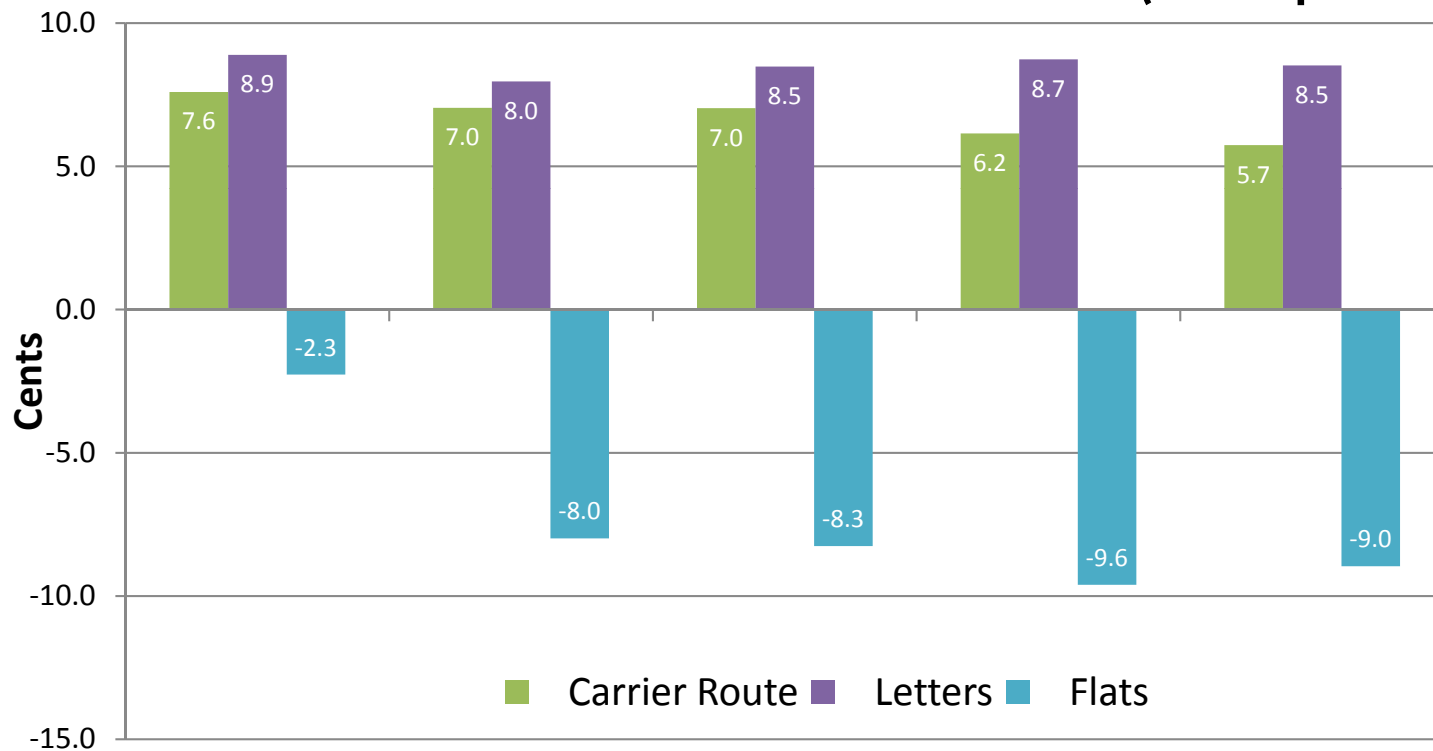
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Total Contribution = \$5,341 m

Recent Regulatory Activity – ACD

Findings - Standard Flats

Standard Mail Flats Unit Contribution (Comparison)



| Contribution Gap | 2008 | 2009 | 2010 | 2011 | 2012 |
|-----------------------|------|------|------|------|------|
| Carrier Route - Flats | 9.9 | 15.0 | 15.3 | 15.8 | 14.7 |
| Letters - Flats | 11.2 | 16.0 | 16.7 | 18.3 | 17.5 |

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Recent Regulatory Activity – ACD

Findings - Standard Flats

- Postal Service began making progress on Standard Mail flats' cost coverage
- No changes to the directive in the FY 2010 ACD are necessary
- Postal Service should continue with its three-year plan of cost reductions and rate increases

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Recent Regulatory Activity - ACD

Findings - Non-profit

- Non-profit workshare discounts in the FY 2012 ACD
 - Comments received from the Alliance of Nonprofit Mailers concerning differential between regular worksharing and nonprofit worksharing discounts
 - The Commission found that the discounts varied (in FY 2012) without explanation or justification from the Postal Service.
 - Settlement between ANM and the USPS

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Recent Regulatory Activity - ACD

Findings - Periodicals

□ Volume, Revenue, Cost, and Coverage

| Periodicals FY 2012 Financial Results | | | | |
|---------------------------------------|---------------|------------------|------------------|---------------|
| | Volume | Revenue | Cost | Cost Coverage |
| Within County | 631,286,455 | \$ 66,495,595 | \$ 95,398,328 | 69.70% |
| Outside County | 6,110,064,496 | \$ 1,656,732,110 | \$ 2,306,203,681 | 71.84% |
| Total | 6,741,350,951 | \$ 1,731,485,915 | \$ 2,401,602,009 | 72.10% |
| | | | | |
| Periodicals FY 2011 Financial Results | | | | |
| | Volume | Revenue | Cost | Cost Coverage |
| Within County | 661,561,122 | \$ 69,180,835 | \$ 89,249,728 | 77.51% |
| Outside County | 6,415,178,344 | \$ 1,743,551,087 | \$ 2,340,773,780 | 74.49% |
| Total | 7,076,739,466 | \$ 1,821,135,301 | \$ 2,430,023,509 | 74.94% |

72.10%

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Recent Regulatory Activity - ACD

Findings - Periodicals

□ Service Performance (% on time)

| On-Time Service Performance (%) FY 2012 | Compare | | | | Annual | Target |
|---|-----------|-----------|-----------|-----------|-------------|--------|
| | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 | | |
| Destination Entry Outside County | 46.3 | 66.9 | 83.1 | 84.6 | 69.8 | 91 |
| End-to-End Outside County | 43.3 | 57.9 | 74.3 | 66.6 | 59.9 | 91 |
| Within County | 45.9 | 65.8 | 82.1 | 82.6 | 68.7 | 91 |
| Overall | 45.9 | 65.8 | 82.1 | 82.6 | 68.7 | 91 |

| On-Time Service Performance (%) FY 2011 | Compare | | | | Annual | Target |
|---|-----------|-----------|-----------|-----------|-------------|--------|
| | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 | | |
| Destination Entry Outside County | | 78.7 | 77.8 | 74.3 | 77 | 91 |
| End-to-End Outside County | | 69.2 | 70.1 | 65.4 | 69.9 | 91 |
| Within County | | 77.9 | 76.2 | 72.4 | 75.5 | 91 |
| Overall | 76.7 | 77.9 | 76.2 | 72.4 | 75.5 | 91 |

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Recent Regulatory Activity - ACD

Findings - Periodicals

□ Historical financial results (millions)

| <u>Historical Financial Results (Millions)</u> | | | | | |
|--|---------------|----------------|-------------|----------------------|---------------------|
| <u>Year</u> | <u>Volume</u> | <u>Revenue</u> | <u>Cost</u> | <u>Cost Coverage</u> | <u>Contribution</u> |
| 2007 | 8,795 | \$ 2,188 | \$ 2,636 | 83.01% | \$ (448) |
| 2008 | 8,605 | \$ 2,295 | \$ 2,732 | 84.00% | \$ (437) |
| 2009 | 7,953 | \$ 2,038 | \$ 2,680 | 76.04% | \$ (642) |
| 2010 | 7,269 | \$ 1,879 | \$ 2,490 | 75.46% | \$ (611) |
| 2011 | 7,077 | \$ 1,821 | \$ 2,430 | 74.94% | \$ (609) |
| 2012 | 6,741 | \$ 1,732 | \$ 2,402 | 72.10% | \$ (670) |
| | | | | | \$ (3,417) |



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Recent Regulatory Activity - ACD

Findings - Periodicals

□ Historical Financial Results (unit basis)

| | <u>Cost/Pc</u> | <u>Revenue/ Pc</u> | <u>Contribution/ Piece</u> |
|-------------|----------------|------------------------|--------------------------------|
| 2007 | \$ 0.300 | \$ 0.249 | \$ (0.051) |
| 2008 | \$ 0.318 | \$ 0.267 | \$ (0.051) |
| 2009 | \$ 0.337 | \$ 0.256 | \$ (0.081) |
| 2010 | \$ 0.343 | \$ 0.258 | \$ (0.084) |
| 2011 | \$ 0.343 | \$ 0.257 | \$ (0.086) |
| 2012 | \$ 0.356 | \$ 0.257 | \$ (0.099) |



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Recent Regulatory Activity - ACD

Findings - Periodicals

□ Historical Financial Results (unit basis)

| | Periodicals OC Flats Mail Processing Cost 1999 - 2012 | | | | | | | | Percent Change | |
|---------------------|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|---------------------|---------------------|
| | <u>1999</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> | <u>1999 to 2012</u> | <u>2007 to 2012</u> |
| Plant Man | 1.47 | 0.92 | 1.10 | 1.02 | 1.26 | 1.19 | 1.20 | 1.21 | -18% | 10% |
| NONMods | 3.36 | 4.42 | 4.73 | 5.19 | 5.74 | 5.10 | 4.71 | 4.89 | 46% | 3% |
| Plant Mech | 1.94 | 3.33 | 3.55 | 3.34 | 3.67 | 3.48 | 4.80 | 5.22 | 169% | 47% |
| Bundle | 3.00 | 2.68 | 2.74 | 2.76 | 2.71 | 2.60 | 2.51 | 2.45 | -18% | -10% |
| Plant Allied | 2.70 | 4.15 | 4.62 | 4.54 | 4.54 | 4.34 | 4.10 | 4.30 | 59% | -7% |
| Other Allied | 0.58 | 1.03 | 1.11 | 1.63 | 1.68 | 1.91 | 1.81 | 1.83 | 217% | 65% |
| Total | 13.05 | 16.52 | 17.83 | 18.48 | 19.60 | 18.62 | 19.12 | 19.92 | 53% | 12% |

| | Periodicals CRA Unit Cost | Mail Processing | Delivery | Contract Transportation | Other |
|--------------------------|--------------------------------------|----------------------------|-----------------|------------------------------------|--------------|
| FY10 | 34.25 | 18.62 | 12.24 | 3.25 | 0.14 |
| FY11 | 34.34 | 19.12 | 11.97 | 3.09 | 0.16 |
| FY12 | 35.62 | 19.92 | 12.06 | 3.53 | 0.12 |
| Cumulative Change | | | | | |
| | 1.37 | 1.29 | (0.18) | 0.28 | (0.02) |
| | 4.0% | 6.9% | -1.5% | 8.7% | -15.2% |

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Recent Regulatory Activity - ACD

Findings - Periodicals

- Directed the Postal Service to review its operational strategy to assess what cost savings measures are working, and how they could be improved
- Encouraged the Postal Service to evaluate whether it can change workshare discounts and pricing structure to reverse the negative trend

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Recent Regulatory Activity – ACD

Findings - First-Class Mail

First-Class Mail Presort Coverage and Passthrough

- FCM Presort Cost Coverage is 292%
- The 5-digit Workshare discount passthrough was 77.4%

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Recent Regulatory Activity – ACD

Negotiated Service Agreements

- Competitive NSAs continue to show significant growth for postal revenues
- Market dominant NSAs are more challenging, to review and to evaluate

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Recent Regulatory Activity – ACD

Competitive Negotiated Service Agreements

- 355 Competitive NSAs approved since the PAEA
 - ▣ Competitive NSAs required to cover attributable cost
 - ▣ Collectively, competitive products must contribute to institutional costs of the Postal Service (currently 5.5%)

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Recent Regulatory Activity – ACD

Market Dominant Negotiated Service Agreements

- 17 Market Dominant NSAs reviewed since 2009
 - ▣ Each Market Dominant NSA must be available on public and reasonable terms to similarly situated mailers and either
 - improve the net financial position of the Postal Service
 - Reduce costs; or
 - Increasing overall contribution
 - or Enhance the performance of mail preparation, processing, transportation, or other functions

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Regulatory Issues Ahead

Future Innovations

- As pressures continue to mount:
 - ▣ Pressure to reduce costs (e.g. 5-day delivery)
 - ▣ Pressure to increase revenue (e.g. competing in existing markets, Valasis NSA)
 - ▣ Pressure to drive productivity (e.g. increased worksharing)

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Regulatory Issues Ahead

Delivery Frequency

- The Postmaster General announced the Postal Service's intention to move to 5-day mail delivery and 6-day package delivery
 - ▣ Revised proposal is to address concerns:
 - Growth in parcel market
 - Reliance on parcels for prescription drug delivery
- In light of Appropriations bill language, the Board of Governors' issued an April 10th Press release to postpone implementation
- 2010 Advisory Opinion methodology with updated costs: \$1.744 billion in annual savings
- Access to the mailbox:
 - ▣ Commission recommended newspapers have access to the mailbox
 - ▣ If new request filed, similar recommendation for periodicals/flats could be considered

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Regulatory Issues Ahead

Challenges and Opportunities

- Challenge: maintaining solvency in light of volume declines
 - ▣ Volume falling faster than the Postal Service can pull costs out of the system
- Opportunities:
 - ▣ Piggybacking on the 5-day mail delivery proposal: Dynamic routing
 - New delivery paradigm for the Postal Service, shifts focus to efficient routing similar to its competitors
 - ▣ Drive efficiency by sending the right signals through workshare discounts to incentivize “cheap” mail
 - ▣ Focus on the core competencies of the organization

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Regulatory Issues Ahead

Procedures for Nature of Service Cases Docket RM2012-4

- Commission instituted a rulemaking to revise procedures for Nature of Service (Advisory Opinion) cases
 - ▣ Law requires a “hearing on the record”
 - ▣ Streamlining process to the extent due process allows
- Next Steps: Proposed Rules

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Regulatory Issues Ahead

Review of the PAEA and Ratemaking

- The 2006 law tasked the Commission with reviewing the Postal Accountability and Enhancement Act, including its modern system of ratemaking, 10 years after implementation
- 39 U.S.C. 3622(d)(3) provides that the Commission must evaluate if the system is achieving the objectives of the section, while taking into account the factors.
 - ▣ If the Commission determines the system is not achieving the objectives while taking into account the factors, it may, after a notice and comment procedure and by regulation, establish a new system as necessary.

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Regulatory Issues Ahead

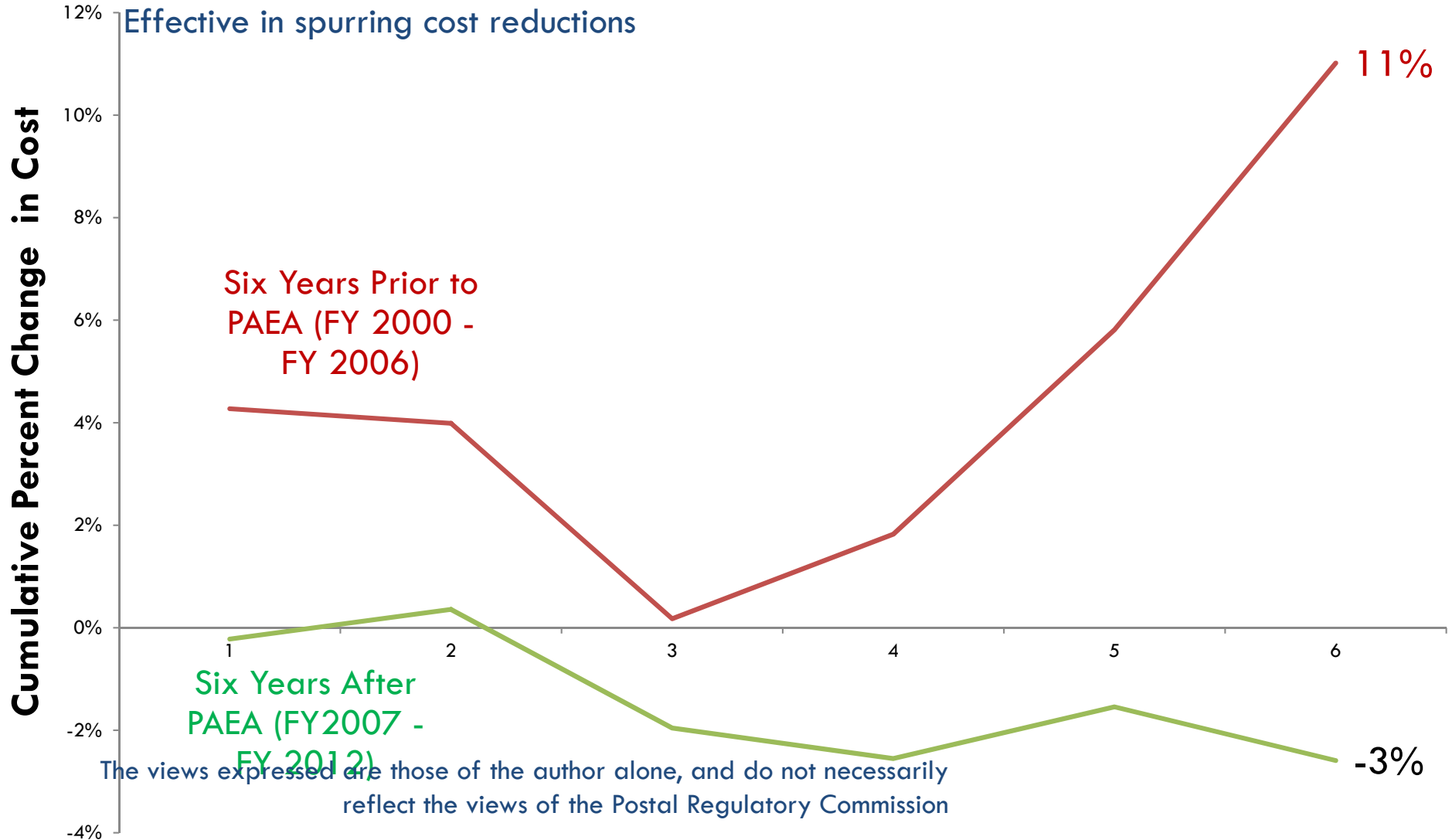
Review of the PAEA and Ratemaking

- Price cap
 - ▣ Effective in spurring cost reductions
 - ▣ Effective at constraining price increases
 - ▣ Challenging to maintain adequate revenues

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Regulatory Issues Ahead

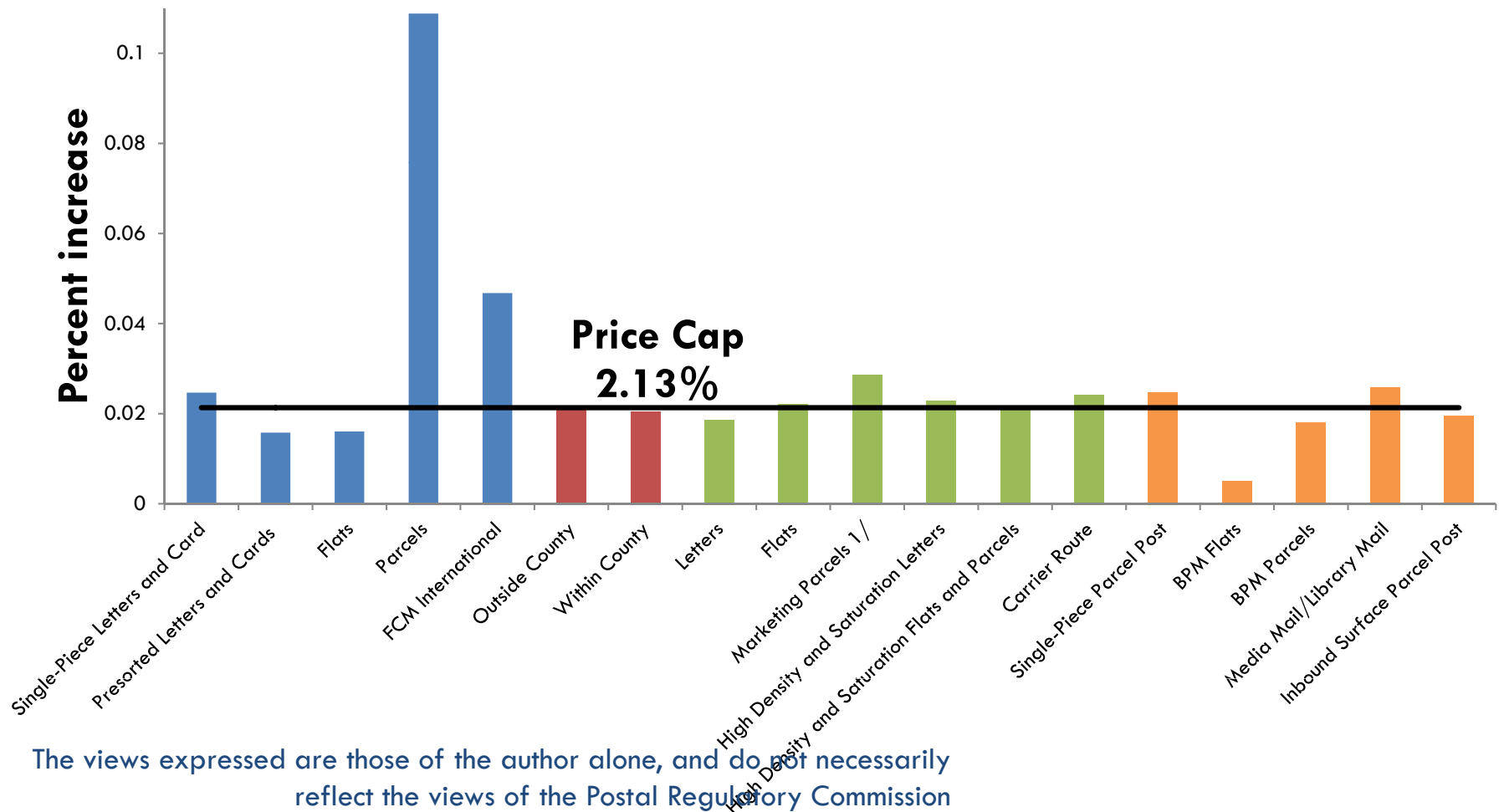
Review of the PAEA and Ratemaking



Regulatory Issues Ahead

Review of the PAEA and Ratemaking

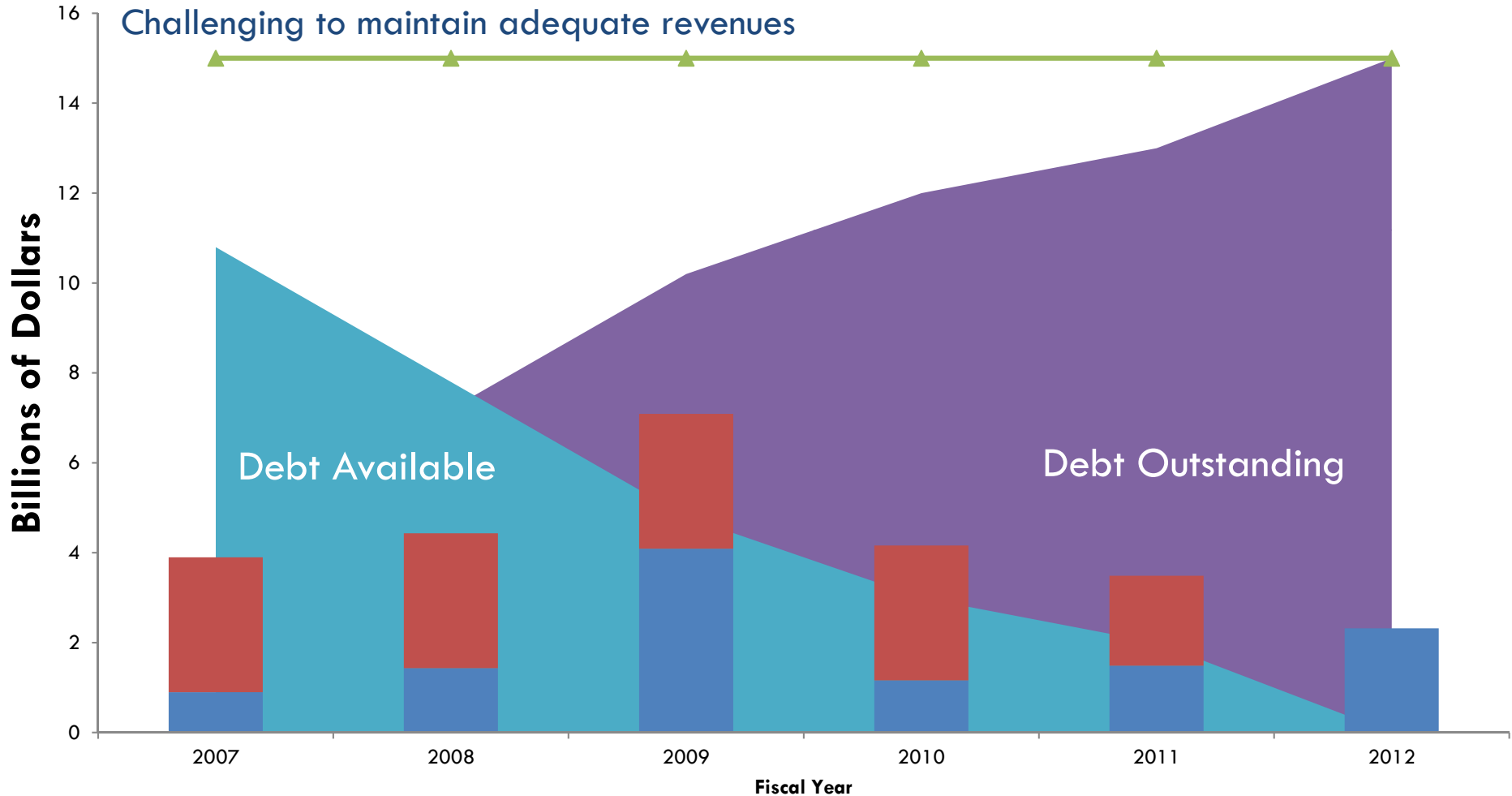
Effective at constraining price increases



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Regulatory Issues Ahead

Review of the PAEA and Ratemaking

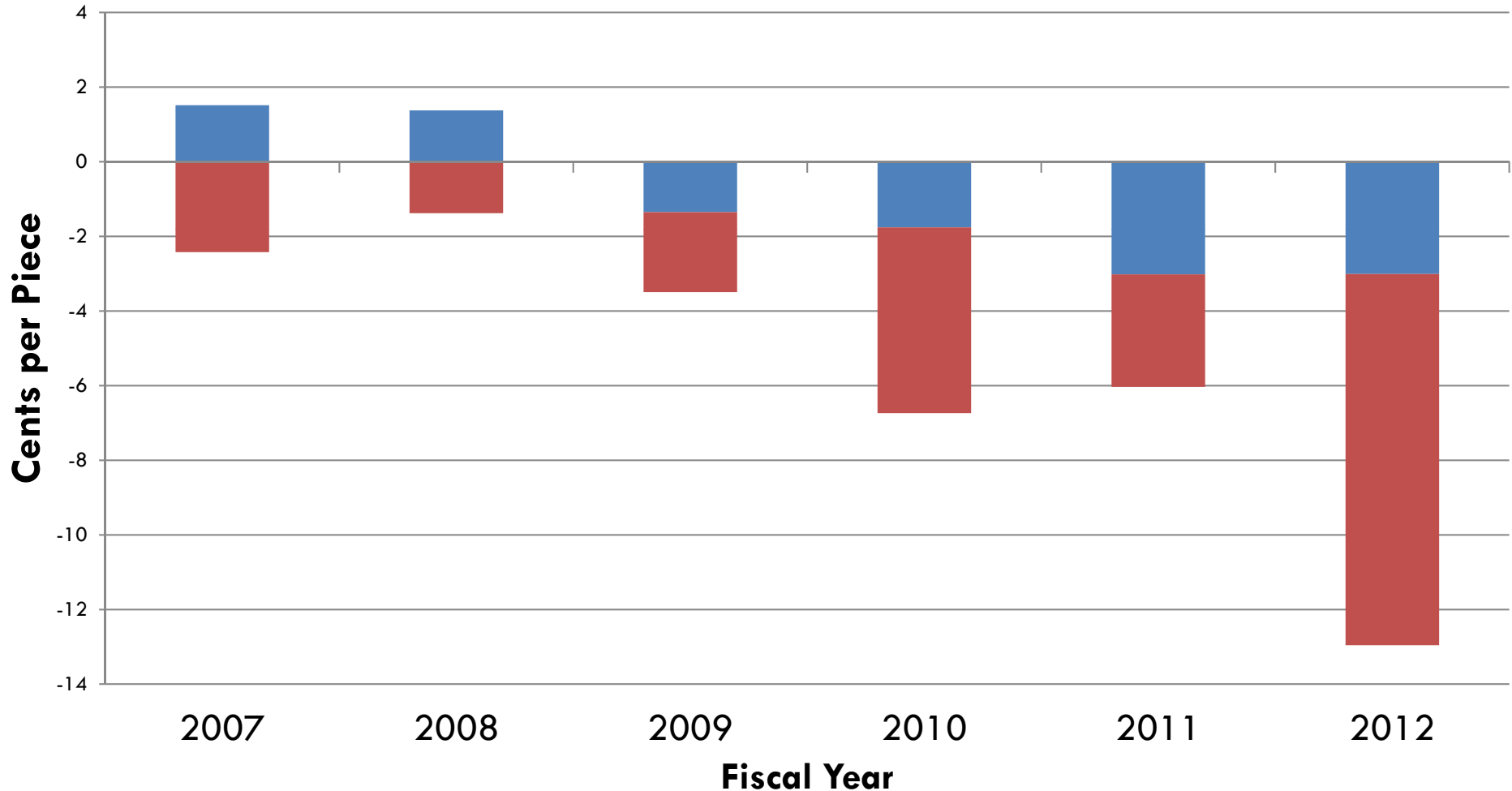


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■ Cash Balance EOY ■ Annual Borrowing Limit ▲ Debt Limit

Regulatory Issues Ahead

Review of the PAEA and Ratemaking



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■ Net Revenue per Piece w/o RHBF ■ Net Revenue Per Piece with RHBF

Challenges and Reform

Action Items

- The Commission brings a unique perspective to postal reform – independent of the Postal Service
 - ▣ Consider the “on the record” requirement for hearings in Nature of Service (Advisory Opinion) cases
 - ▣ Maintain prospective review for changes in the nature of postal services and competitive NSAs
 - ▣ Raise the market test revenue cap for Market Dominant products to allow for meaningful market tests
 - ▣ Re-amortize the current mandated payments into the Postal Service Retiree Health Benefit Fund (PSRHBF)

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Challenges and Reform

Options on the Table

□ Post-PAEA Nature of Service Review

| Proposed Change | Approx. Annual Savings (\$Billions) |
|-----------------------------|--|
| Saturday Delivery | \$1.744 (PRC Estimate: N2010-1) |
| Mail Processing Realignment | \$.45 - 1.96 (PRC Estimate N2012-1) |
| POStPlan | \$.39 - .70 (PRC Estimate N2012-2) |
| <u>Total</u> | <u>\$2.84 – 4.40</u> |

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Closing



- Role of Commission moving forward
- The Universal Service Obligation

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