Office of Inspector General
United States Postal Service

Postal Service Revenue: Structure, Facts, and Future Possibilities

October 6, 2011

Prepared by U.S. Postal Service Office of Inspector General
Risk Analysis Research Center
Report Number: RARC-WP-12-002

Postal Service Revenue: Structure, Facts, and Future Possibilities

Executive Summary

The Postal Service's future financial health depends on its ability to cut costs and generate sufficient revenue to support its operations. In the past, volume growth paid for expansion of the delivery network. Now, new digital technologies are transforming the communications marketplace by delivering information instantaneously, regardless of distance, at a decreasing cost. Because of this profound change, postal services operate in a new business environment that simultaneously threatens traditional mail segments and creates novel opportunities.

The Postal Accountability and Enhancement Act (PAEA) became law in 2006, the same year that mail volumes reached a high point of 213 billion pieces. Soon after, the economic recession triggered decreases in spending and declines in mail volume. At the same time, the move to electronic delivery alternatives accelerated, as mailers looked to save costs and increase time responsiveness. Finally, the precipitous loss of volume and revenue exposed the costly retiree health benefit prefunding requirement established by PAEA, and the Postal Service began to suffer through record economic losses and was unable to raise market dominant product prices due to the CPI-based cap.

In the context of this very difficult financial situation, this paper will analyze the major components of the Postal Service's revenue structure in fiscal year (FY) 2010 as well as substantive product, business segment, and customer trends. Next, it will assess existing opportunities to extract further value from its core business as well as to explore new initiatives permissible under the existing framework. Finally, it will discuss future options and policy considerations in a new era. Just as other organizations have responded to volume declines in their core products and services, the Postal Service could benefit from an aggressive response. Ultimately, the path forward may require a new strategic direction that offers products and services that meet America's changing needs.

In our discussion of Postal Service revenue, we present 10 key points:

1. Four main product lines — First-Class Single Piece, First-Class Workshare, Standard Regular, and Standard Enhanced Carrier Route (ECR) — provided 75 percent of revenue, 94 percent of volume, and 86 percent of contribution in FY 2010.

2. Advertising mail is a strong, potentially significant growth opportunity. The Winterberry Group estimates that direct mail advertising will increase by 5.8 percent

in 2011. Once mail volume rebounds, the Postal Service must again be sensitive to the return of “Do Not Mail” campaigns and environmental concerns related to perceived excessive solicitations.

3. Although the Postal Service infrastructure serves the entire nation, large business mailers generate the majority of revenue. In FY 2010, commercial mailers accounted for 73 percent of total revenue and a tiny fraction of the top one percent alone generated about half of total revenue.[1]

4. Despite encouraging growth, the Expedited and Package Services (EPS) segment contains strong competitors with significant market power. The Postal Service earned 15 percent of its revenue from these categories in FY 2010. Even with robust growth, it is extremely unlikely that EPS revenue can offset the projected declines in First-Class Mail (FCM).

5. The Postal Service’s latest product proposals and offerings are innovative, rooted in its core business, and leverage opportunities within existing product lines. However, it is important that the discount-based proposals do not unnecessarily put contribution at risk.

6. As mail volumes decline, collecting accurate revenue will become increasingly essential for survival. Simplifying and streamlining standards, products, and pricing structures can reduce complicated rules and systems and attract new mailers.

7. Under the current price cap rules, the Postal Service and the Postal Regulatory Commission (PRC) lack the practical flexibility to adjust prices to ensure that revenue covers costs for major product areas, as mandated by PAEA.

8. Experts anticipate that mail volumes will decline by between 15 and 34 percent by 2020. Either prediction supports the argument that, in addition to cost-cutting measures, substantive changes to the revenue structure are necessary to put the Postal Service on sound financial footing and continue supporting the universal service obligation (USO).

9. Most foreign posts view diversification as necessary to survival and derive at least 40 percent of their revenue outside the traditional hard-copy mail business. The Postal Service has an undiversified portfolio with only about 15 percent of its revenue from non-mail sources.

10. Our analysis suggests that in the long term, the Postal Service must have the flexibility to reduce costs and increase revenue or risk greatly narrowing the scope of self-funded, hard-copy universal service for the American people.

[1] Some of these top customers are third-party consolidators who handle the mail of numerous other customers (original mail owners). Nonetheless, it is the consolidator who is dealing directly with the Postal Service and is paying postage.

Table of Contents

Revenue Structure, Facts, and Trends ... 1
- Revenue by Product ... 1
- Revenue by Business Segment ... 5
- Revenue by Customer Segment ... 11

Revenue Possibilities under the Existing Framework ... 13
- Revenue Assurance ... 13
- Pricing Enhancements ... 14
- Marketing and Product Development Opportunities ... 17

Revenue Possibilities under an Alternative Framework ... 20
- Barriers to the Path Forward ... 20
- Possibilities under an Alternative Framework ... 22

Conclusion ... 24

Tables

Table 1 Revenue, Volume, and Contribution by Product, FY 2010 2

Table 2 Selected First-Class Mail and Standard Mail Categories, FY 2010 3

Table 3 Revenue by Business Segment, FY 2010 6

Table 4 Total U.S. Advertising Expenditures by Media in 2010.......................... 8

Table 5 First-Class Mail Support of Delivery Network 13

Table 6 UPS Fuel Surcharges, FY 2008 to FY 2010....................................... 16

Table 7 Examples of Initiatives Feasible under Current Framework 19

Figures

Figure 1: Revenue and Volume Shares, FY 2010 1

Figure 2: Revenue per Pound, by Mail Class 3

Figure 3: Four-Year Volume Trend, FY 2006 to FY 2010.................................... 4

Figure 4: Mail Volume by Class, FY 2003 to FY 2010 5

Figure 5: Share of Revenue by Business Segment, FY 2010.............................. 6

Figure 6: How Much Ad Mail Is Too Much?... 9

Figure 7: Domestic Mail Revenue by Entry Point, FY 2010 14

Figure 8: Value-Based Versus Cost-Based Pricing 16

Figure 9: Proportion of Non-Mail Revenue, by Post 23

Appendices

Appendix A Postage Payment Methods 26

Appendix B Market Dominant Money Losing Products 2010 27

Appendix C Nominal Prices for Letter Mail within Europe...................................... 28

Postal Service Revenue: Structure, Facts, and Future Possibilities

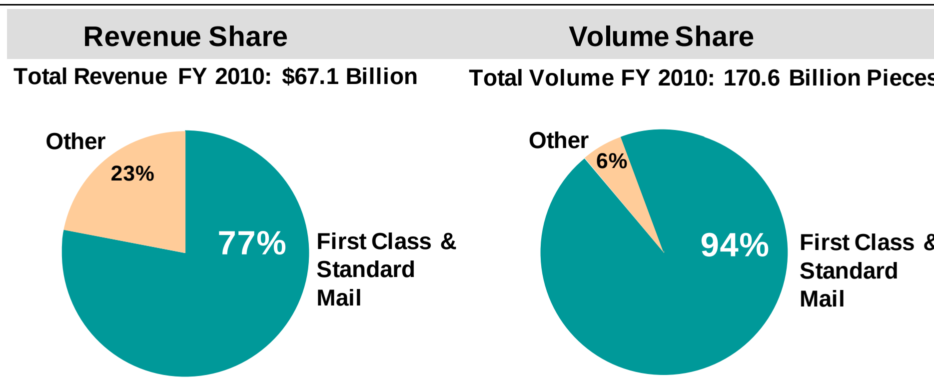
Revenue Structure, Facts, and Trends

This section of the paper examines Postal Service revenue structure by product, business application, and customer segment. It also summarizes facts and trends related to revenue.

Revenue by Product

The Postal Service's line of products has evolved since its founding. However, First-Class Mail (FCM) remains the flagship product and accounts for the majority of Postal Service revenue. Standard Mail, which has primarily been advertising, is the largest product by volume. As Figure 1 shows, these two mail classes accounted for 77 percent of revenue and 94 percent of volume in FY 2010. As currently structured, the viability of the Postal Service continues to rely on the resilience of hard-copy mail in an increasingly electronic age.

Figure 1: Revenue and Volume Shares, FY 2010



Source: U.S. Postal Service, Cost and Revenue Analysis (CRA) and Revenue, Pieces, and Weight (RPW) Report, FY 2010.

FCM is critical to the financial viability and essential mission of the Postal Service, yet it is declining at an alarming rate. Since reaching its peak in 2001, FCM volume has declined an unprecedented 25 percent to 78 billion pieces. Last year, Boston Consulting Group (BCG) projected a further decline to 53 billion pieces by 2020.[2] The cause for

[2] The Boston Consulting Group, "2020 forecast sees ongoing decline in First-Class Mail," http://about.usps.com/future-postal-service/bcg-selected-slides.pdf, p. 3.

alarm is real, as FCM has historically been the primary product to finance the Postal Service's fixed cost delivery network. Even in 2010, FCM alone provided approximately 66 percent of the Postal Service's total financial contribution or profit.[3] For every FCM piece lost, it takes an average of three pieces of Standard Mail to replace its contribution.[4] In addition, FCM is one of the flagship products that justify the Postal Service's status as a government entity with monopoly protection in order to meet the universal service obligation (USO).

While the Postal Service can certainly improve its offerings and has a number of potential growth areas, there is not enough revenue in other existing product areas to make up for significant declines in FCM and Standard Mail. Table 1 shows detailed information on revenue, volume, and profit contribution by major mail category.

Table 1: Revenue, Volume, and Contribution by Product, FY 2010

	Revenue		Volume		Revenue/	Contribution	
Mail Class	(millions)	share	(millions)	share	Piece	(millions)	share
First-Class Mail	$34,026	51%	78,549	46%	$0.43	$16,950	66%
Standard Mail	17,331	26%	82,524	48%	0.21	5,512	22%
Priority Mail	5,657	8%	809	0%	6.99	1,410	6%
Package Services	1,516	2%	659	0%	2.30	-185	-1%
Periodicals	1,879	3%	7,269	4%	0.26	-611	-2%
International Mail	1,490	2%	271	0%	5.46	513	2%
Express Mail	828	1%	43	0%	19.46	332	1%
Parcel Select	569	1%	297	0%	1.92	149	1%
Other Mail	0	----	153	0%	----	0	0%
Subtotal Mail	**$63,296**	**94%**	**170,574**	**100%**		**$24,070**	**94%**
Special Services/Other	3,781	6%	N/A		N/A	1,430	6%
Total	**$67,077**	**100%**	**170,574**	**100%**		**$25,500**	**100%**

Note: Share percentage may not total due to rounding.

Source: U.S. Postal Service, Cost and Revenue Analysis (CRA) and Revenue, Pieces, and Weight (RPW) Report, FY 2010.

While Table 1 presents the total revenue per piece and contribution by major mail category, analyzing revenue per pound allows a reasonable "apples-to-apples" comparison since piece weight varies considerably between categories. Figure 2 highlights the dramatic differences in revenue per pound across the four major mail classes and yields some interesting insights. For example, while many have asserted that Periodicals lose money because of high costs, a major contributor could be its low revenues. It is interesting to note that FCM generates more than 13 times as much revenue per pound as Periodicals. And this is true despite the fact that beyond transportation, where Periodicals is fully a ground product, both receive expedited handling.

[3] Contribution can loosely be defined as "profit." Technically, it represents revenue minus volume variable and product-specific costs.
[4] U.S. Postal Service, Cost and Revenue Analysis (CRA), FY 2010.

Figure 2: Revenue per Pound, by Mail Class

Source: U.S. Postal Service, Revenue, Pieces, and Weight (RPW) Report, FY 2010.

First-Class Mail and Standard Mail Trends

Although the Postal Service's line of products has grown and evolved over the years, FCM and Standard still represent 88 percent of total contribution.[5] Table 2 presents the Postal Service's revenue, volume, and contribution for the four major segments of FCM and Standard.

Table 2: Selected First-Class Mail and Standard Mail Categories, FY 2010

	Revenue		Volume		Profit Contribution	
Category	**(millions)**	**share**	**(millions)**	**share**	**(millions)**	**share**
First-Class Single-Piece	$16,408	24%	30,957	18%	$5,769	23%
First-Class Workshare	16,570	25%	46,912	28%	10,753	42%
Standard Regular	12,386	18%	56,033	33%	3,339	13%
Standard ECR	4,808	7%	26,220	15%	2,074	8%
Total	$50,172	75%	160,122	94%	$21,935	86%

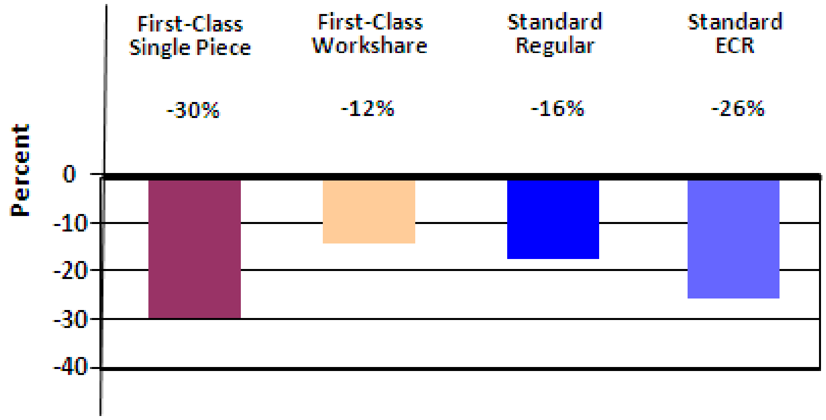
Note: Share percentage may not total due to rounding.

Source: U.S. Postal Service, Cost and Revenue Analysis (CRA) and Revenue, Pieces, and Weight (RPW) Report, FY 2010.

In terms of volume, all four categories experienced double-digit declines between FY 2006 and FY 2010, although Standard stabilized in 2010 and grew significantly in early 2011. Of particular concern is First-Class Single-Piece volume, which fell 30 percent since FY 2006. Figure 3 illustrates this alarming trend.

[5] Total mail class contribution for FCM and Standard includes Inbound and Outbound International as well as fees that are not associated with individual subclasses. This accounts for the different profit contributions of the full class (88 percent) versus the major sub-segments (86 percent).

Figure 3: Four-Year Volume Trend, FY 2006 to FY 2010[6]



Source: U.S. Postal Service, Cost and Revenue Analysis (CRA) and Revenue, Pieces, and Weight (RPW) Report, FY 2010.

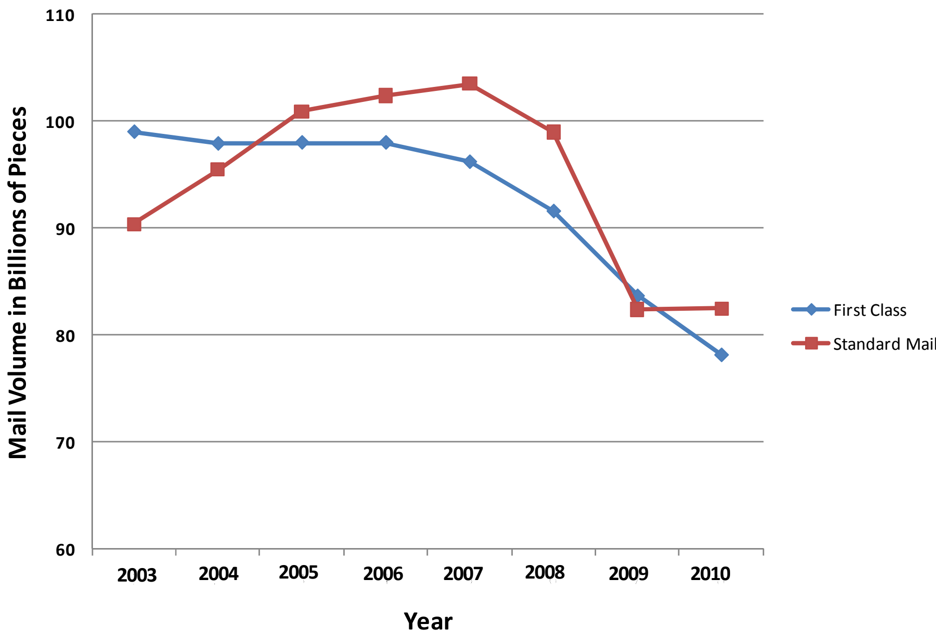
Since FY 2007, total FCM volume declined 18 billion pieces. In FY 2010 alone, FCM declined 5.6 billion pieces or 6.5 percent[7] with Single Piece decreasing by 9.8 percent and Presort declining by 4.2 percent.[8] According to BCG's inflation-adjusted projections, the revenue per delivery point per day for FCM averaged $1 in 2000, fell to 70 cents in 2009, and will continue to decline to 40 cents by 2020.[9] In addition to the revenue per delivery point implications, the Postal Service built its current network to process and deliver FCM. The decline in FCM threatens the organization's original governmental structure and its underlying monopoly protection.

Standard Mail Cannibalizing First-Class Mail

Standard Mail volume surpassed FCM for the first time in FY 2005. BCG concluded that much of the FCM volume loss during the economic downturn will return as less profitable Standard Mail.[10] Figure 4 suggests that mailers may already be making the shift from FCM to Standard, despite Standard's higher requirements for mail preparation and the lack of features such as free forwarding.

[6] We use the former mail class-related names to allow comparison of data from previous years.
[7] U.S. Postal Service, Cost and Revenue Analysis (CRA), FY 2010, p. 17.
[8] OIG analysis of postal domestic volume history, 2010, and RPW reports
[9] The Boston Consulting Group, *Projecting U.S. Mail Volumes to 2020 Final Report Detail*, March 2, 2010, http://about.usps.com/future-postal-service/bcg-detailedpresentation.pdf, p. 12.
[10] The Boston Consulting Group, *Projecting U.S. Mail Volumes to 2020*, March 2, 2010, http://about.usps.com/future-postal-service/gcg-narrative.pdf, p. 2.

Figure 4: Mail Volume by Class, FY 2003 to FY 2010



Source: U.S. Postal Service Annual Report, 2003-2010.

A number of factors make Standard a viable replacement for FCM. Mail rule changes permit many types of documents that were formerly sent via FCM to be sent Standard. For example, while corporate annual reports and similar documents were formerly sent FCM or Priority Mail, most are now delivered via Standard or offered electronically.[11] Moreover, by using drop ship services, mailers can get service levels equal to or even better than FCM, at a greatly reduced price. Soon, service performance measurements, like the Intelligent Mail barcode (IMb), will provide track and trace capabilities as well as critical data.[12] Even with an economic recovery, business mailers will use Standard Mail because of the lack of cost-justified differentiation in service relative to FCM. At about 7 cents per piece instead of 22 cents per piece for FCM, Standard Mail provides less than one-third the profit contribution per piece towards funding the Postal Service's network.[13] Therefore, it takes more than three pieces of Standard to cover the loss of only one average piece of FCM.

Revenue by Business Segment

Even though profit contribution is the real issue, examining revenue by industry usage categories also yields interesting insights. Table 3 and Figure 5 present revenue by business use of the mail. The correspondence and transactions segment, which includes mail such as statements, payments, cards, and letters, is the largest revenue

[11] UPS Mail Innovations aggregates many annual reports and delivers them via Standard Mail.
[12] "Rationalizing postal costing in the 21st century," *Postal Journal,* April 28, 2011.
http://postaljournal.com/2011/04/28/rationalizing-postal-costing-in-the-21st-century/.
[13] U.S. Postal Service, Cost and Revenue Analysis (CRA), FY 2010.

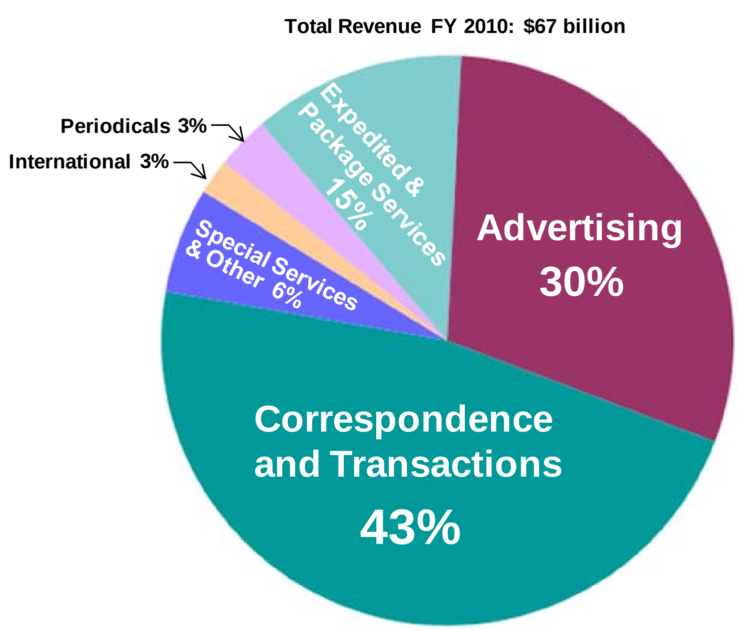
segment. However, this segment is the most vulnerable to losses from electronic alternatives. About one-third of all revenue comes from advertising, but this volume represented 59 percent of all mail received by households in 2010.[14] The third-largest segment, expedited and package products, comprises a much lower proportion of revenue, but is part of a growing, competitive market.

Table 3: Revenue by Business Segment, FY 2010

Business Segment	Revenue (billions)	Description
Correspondence and Transactions	$ 29	Letters, cards, notices, financial documents, bills, statements, payments, and donations
Advertising	20	Customer acquisition and promotions (First-Class advertising and Standard)
Expedited and Package Services	10	Express Mail, Priority Mail, packages, and printed matter
Periodicals	2	Magazines and newspapers
International	2	All international
Other	4	Special Services and others
Total	**$ 67**	

Source: Estimated based on U.S. Postal Service Cost and Revenue Analysis (CRA), FY 2010, Household Diary Study, FY 2010, and OIG analysis.

Figure 5: Share of Revenue by Business Segment, FY 2010



Source: Estimated based on U.S. Postal Service Cost and Revenue Analysis (CRA), FY 2010, Household Diary Study, FY 2010, and OIG analysis.

[14] U.S. Postal Service, *The Household Diary Study: Mail Use & Attitudes in FY 2010*, April 2011, http://www.prc.gov/docs/73/73501/USPS_HDS_FY10_FINAL_.pdf, p. 40.

Correspondence and Transactions

Correspondence and Transactions has historically been the most important segment due to its size and profitability. In the past, it was the least affected by economic swings but now is the most susceptible to electronic diversion. This trend is most pronounced in FCM Single Piece, which has declined significantly since the early 1990s. Once the dominant product, it accounts for less than 20 percent of mail volume today.[15] Personal correspondence (e.g., greeting cards, letters) experienced average annual declines of 3.7 percent in the last decade[16] and 12.2 percent from FY 2008 to 2010.[17] Yet half of all correspondence is actually business-to-household mail,[18] which historically exhibited more resilience to diversion; however, much of this portion may gradually shift to electronic alternatives in the relatively near future.

In terms of transactional mail, the traditional bellwether of the economy and determinant of First Class Mail trends, bills and statements showed no overall decline from 2002 to 2007, although per household decline did occur.[19] The housing and credit bubble likely fueled the growth of FCM in the early 2000s. However, bills and statements then started to fall after a long period of relative stability. Between 2008 and 2010, declines increased at a 7.2 percent compound annual growth rate (CAGR)[20] and resulted in a total decline of 13.8 percent over the period.[21] Changing business practices prompted by the economic downturn, not e-diversion, appear to be the primary driving forces behind this development.

Because of the large volume and high profitability, losing bill presentment to electronic alternatives has dire revenue implications for the Postal Service.

Recent trends for bill presentment — bills and statements sent to customers — differ from the trends for bill payments sent by customers. In 2010, for the first time, fewer than half of all bills were paid by mail,[22] reflecting changes in household payment practices. On the other hand, customers are still reluctant to give up free hard copy bills and statements in favor of online versions. In 2010, only 9 percent of presentments were solely online.[23] Consumers reducing consumption and consolidating their credit cards, and businesses bundling bills such as landline, mobile, and cable, caused much of the recent decline in presentment.

The Postal Service could monitor conversion rates to anticipate a shift to greater online adoption, as bill and statement presentment are extremely vulnerable to future electronic diversion. Mailers may find it hard to get customers to give up this “freebie” and, in fact, printed statements continue to provide value to businesses as a customer

[15] OIG analysis of The Household Diary Study and RPW reports.
[16] U.S. Postal Service, *The Household Diary Study: Mail Use & Attitudes in FY 2010*, Table A8-1.
[17] Ibid., p. 24.
[18] Ibid., p. 27.
[19] Ibid., Table A8-1.
[20] Infotrends, *Addressing the Decline in First-Class Mail- Analysis of Trends Driving Change*, July 2011, p. 7.
[21] U.S. Postal Service, *The Household Diary Study: Mail Use & Attitudes in FY 2010*, p. 29.
[22] Ibid., p. 33.
[23] Ibid.

relationship tool.[24] Nonetheless, mailers will continue to look for ways to migrate users online since digital transaction costs are a fraction of mailing costs.[25] Punitive measures like presentment surcharges to receive hard copies could be the next step. Because of the large volume and high profitability of this mail segment, losing bill presentment to electronic alternatives has dire revenue implications for the Postal Service.

Advertising Mail

Advertising mail provides a potentially significant opportunity for the Postal Service to increase revenue. In support of McKinsey's 2010 *Ensuring a Viable Postal Service for America*, the BCG projected an approximate 18 percent increase in Standard Mail letter volume through 2020.[26] Table 4 presents total U.S. advertising expenditures by traditional as well as direct and digital media in 2010. Notably, direct and digital advertising spending is on the rise. Winterberry Group estimated a 6.2 percent increase to $163.9 billion in 2011 and projected that total direct mail spending would increase by 5.8 percent to $47.8 billion in 2011.[27]

Table 4: Total U.S. Advertising Expenditures by Media in 2010

Media	2010 Expenditure by Media (billions)	Change from 2009
TRADITIONAL		
OUTDOOR	$ 6.1	-0.5%
RADIO	$13.5	-4.4%
MAGAZINES	$14.6	-6.2%
NEWSPAPERS	$23.4	-9.2%
CINEMA	$0.6	2.3%
TELEVISION	$56.4	17.5%
DIRECT AND DIGITAL		
INSERT MEDIA	$0.8	2.4%
PRINT	$15.0	-3.6%
BROADCAST TV	$23.6	3.8%
DIGITAL	$27.7	8.5%
DIRECT MAIL	$45.2	3.1%
TELESERVICES	$39.5	0.1%
OTHER	$2.6	6.1%
TOTAL	**$269.0**	**2.9%**

Source: Winterberry Group. Outlook 2011: What to Expect in Direct & Digital Marketing, January 2011.

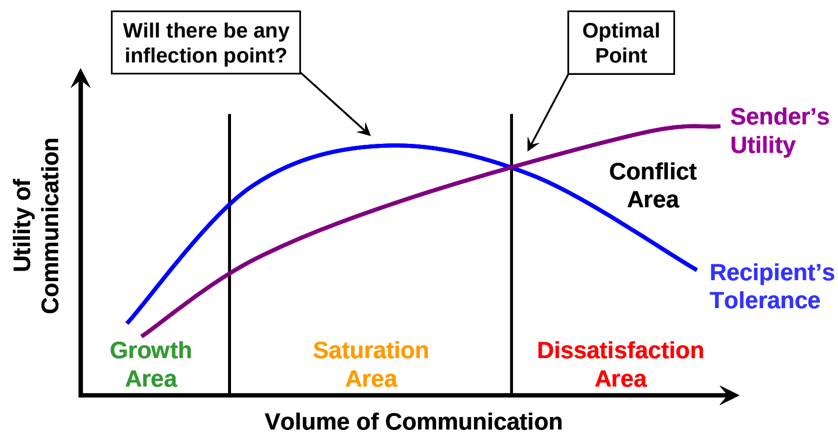
Many advertisers value mail because it affords them measurability of effectiveness as well as a geographic and demographic data link. Since 1990, according to Magna Advertising Group, direct mail's share of total advertising has been relatively consistent

[24] Studies indicate customers still prefer receiving bills in hard copy due to archival, ease-of-use, security, and payment reminder attributes.
[25] In addition to postage costs, total mailing costs include printing, production, and creative costs.
[26] The Boston Consulting Group, *Projection of US mail volume to 2020 Compendium*, December 18, 2009, slide 91.
[27] Bruce Biegel, "Outlook 2011: What to Expect in Direct & Digital Marketing", Winterberry Group, January 13, 2011. slide 12.

while other traditional media's shares have significantly decreased.[28] Now, a new opportunity emerges as many advertisers are combining their mail and online campaigns to better reach their customers.[29]

However, a number of threats may limit this opportunity. For example, unwanted mail and associated environmental concerns (perceived and real) shape and frame the public opinion of advertising mail. Some consumers seem to resist unwanted mail, and increasingly associate unwanted mail with waste. (A corollary of this may prove to be true; consumers accept more advertising mail when it is targeted to their interests and preferences. Figure 6 illustrates this phenomenon.) The usefulness of mail to the sender may eventually exceed the recipients' tolerance.

Figure 6: How Much Ad Mail Is Too Much?



Source: Pitney Bowes Research Project, *Electronic Substitution for Mail: Models and Results; Myth and Reality*. Originally from Nikali and Elkelä, 2003.

The Postal Service has a strong interest in delivering advertising mail that satisfies both senders and recipients. Although a "Do Not Mail" backlash has not yet occurred, this should be a perennial concern for the Postal Service. Some believe the market will naturally address this since marketers will only send advertising mail to the extent it is effective in finding customers. However, the Postal Service may have a role in striking a balance between advertisers' utility in sending and the recipients' tolerance in receiving advertisements. By proactively responding to concerns, researching recipient tolerance, and tracking changes in consumer attitudes, the Postal Service can foster consumer choice and increase the value of direct marketing by encouraging targeted advertising. Mailers could develop more accurate lists of the types of mail customers want to receive. Finely targeted advertising may be an effective way to mitigate recipient concerns, increase value to consumers, and maintain mail as a highly effective medium without adversely affecting overall profitability.

[28] U.S. Postal Service, *The Household Diary Study: Mail Use & Attitudes in FY 2010*, p. 39.
[29] Matthew Swain, "The USPS – History and Opportunity U.S. Postal Review and Emerging Digital Alternatives,"InfoTrends, (presentation at Postal Vision 2020, Crystal City, VA, June 15, 2011).

Perhaps one way to approach this would be to consider raising advertising mail rates. If one assumes that with fewer mail pieces response rates would improve, there could be an interesting advertising paradox. If mailers face higher prices, they will mail less but their response rates could increase.[30] It is possible the Postal Service could price higher, for less volume, but provide more value to all parties — a "win-win-win". Mailers could send fewer pieces, but garner higher response rates. The amount of recipient complaints could decline because "junk" mail perceptions could decrease, as recipients would be receiving less of what they do not want. The Postal Service would collect more revenue and profit contribution. Finally, smaller volumes are also consistent with many of the ongoing opportunities to reduce costs at the Postal Service by shrinking its footprint.

The Postal Service must also be mindful of how the recent, drastic change in revenue structure shifts mail from a two-sided to a one-way medium.[31] Even successfully supplementing revenue gaps from FCM with advertising mail has public policy implications if the Postal Service no longer serves as a two-way medium that links individuals, businesses, and government together.[32] Is there a public need for a one-way advertising and business-generating pipeline presence to uphold universal service? To avoid this dilemma, the Postal Service's advertising mail strategies must focus on quality, relevance, and effectiveness, rather than volume, to keep customers engaged.

Another consideration is the role of advertising mail and other traditional advertising media in a new era. The field is still in a state of flux but it is clear that the advertising pie size and channel slices are changing. The Postal Service must stay abreast of current trends and anticipate shifting market dynamics that will affect core business segments.

Expedited and Package Services

BCG projected parcel volume sent by both consumers and businesses will increase by 40 percent by 2020.[33] E-commerce is growing, but has not reached its full potential due to accessibility, returns, payment, and security concerns. Companies that can solve these shortcomings will garner additional volume.

In 2006, the EPS business of the Postal Service — defined as Priority Mail, Express Mail, Package Services — as well as First-Class and Standard Mail parcels comprised almost 12 percent of total revenue. By 2010, this figure grew to approximately 15 percent of revenue.[34] This is extremely impressive considering that the Postal Service faces successful, aggressive, politically active private-sector competitors with

[30] This could be due to less prospecting. Prospecting can find new customers, but generally has much lower response rates.
[31] Thomas Eisenmann, Geoffrey Parker, and Marshall W. Van Alstyne, "Strategies for Two-Sided Markets," *Harvard Business Review*, October 2006, p. 5.
[32] U.S. Postal Service Office of Inspector General, *Implications of Declining Mail Volumes for the Financial Sustainability of the Postal Service*, Report No. RARC-WP-10-006, September 29, 2010, http://www.uspsoig.gov/foia_files/RARC-WP-10-006.pdf.
[33] The Boston Consulting Group, *Projection of US mail volume to 2020 Compendium*, December 18, 2009, http://www.prc.gov/Docs/68/68381/NALC.T2.Q5.BCG.Projections.Redactd.pdf, slide 135.
[34] OIG analysis of U.S. Postal Service, detailed Revenue, Pieces, and Weight (RPW) data, FY 2006 & 2010.

entrenched market share. While this growth provides room for optimism, it is still a relatively modest piece of total revenue. The core issue regarding EPS business is that even with robust segment growth, the new revenue is unlikely to reach the scale or profit level to compensate for the projected declines in FCM, which has historically covered the Postal Service's fixed cost delivery network.

The Postal Service's EPS market share growth faces a number of specific challenges. First, many customers demand track and trace, which the Postal Service will lack for every domestic product except Express Mail until IMb is fully deployed. Second, while customers are interested in lower prices, they are also demanding consistent, time-definite services. While the Postal Service often offers equal or lower prices, there is a perception from some in the market place that its service is inconsistent across the country. Finally, private-sector competitors develop customized shipping solutions to cater to their largest customer's needs and lock them into long-term arrangements.

Despite these challenges, there are many opportunities. First, although 5-day delivery has been discussed as a cost reduction opportunity, the Postal Service currently has inherent advantages as it delivers to every household 6 days a week without a surcharge. Merely by accepting and delivering on Saturdays, the Postal Service dramatically improves its average delivery times relative to the competition. For example, an item shipped on Thursday with identical two-day service would actually be delivered in two calendar days (Saturday) by the Postal Service, but four days (Monday) by a competitor that does not deliver on Saturdays. By averaging such differences across the week, the Postal Service delivery times average more than one-half a day faster than the competition. Second, while FedEx and UPS lead the high-volume business-to-business markets, it can be very expensive for them to deliver single items to residential addresses and they have instituted surcharges to cover the extra costs. Along with such "last mile" advantages, the Postal Service also may offer unique strengths in rural areas and large residential buildings, where it sometimes has special access. Additionally, new product options, such as the Priority Flat Rate Box, and other cost-effective deferred (2 to 3 day delivery) products offer a bright spot for revenue growth in the weak economy. The Postal Service could use this opportunity to implement improved tracking capabilities and ensure consistent service to retain these new customers even as the economy improves.

Revenue by Customer Segment

While almost every American is a customer of the Postal Service, commercial businesses generate about 73 percent, or $49 billion, of total revenue.[35] The largest of those commercial mailers account for an incredibly high proportion of revenue — a tiny fraction of the top 1 percent of customers account for half of total revenue. The top 50 business customers alone, each of whom spend over $100 million per year with the Postal Service, generated over 20 percent of revenue and almost 28 percent of volume. The 20 largest mailers in FY 2010 include shipping service companies, members of the financial industry, and mail service providers (e.g., presort bureaus and consolidators).

[35] U.S. Postal Service Corporate Business Customer Information Service (CBCIS) for business categories.

In one capacity, this concentration is helpful in that it allows for streamlining mailing standard changes and addresses key customer concerns efficiently. However, it is important to note that while “middle men” like mail consolidators can be very good by serving as a de facto sales force, they do separate the Postal Service from its end customer, the mail owner. Such separation can prevent the Postal Service from hearing the core concerns of the mail owner. For example, it could better understand the different ways that customers use the mail and how the Postal Service could better meet their needs in an increasingly digital age. Only by staying close to the end customer and listening to their needs can the Postal Service truly develop products and services that support their business interests and better serve those customers.

Revenue Possibilities under the Existing Framework

Even under the best-case scenario, FCM is not likely to return to its peak volume levels. If BCG's projections are correct, FCM will generate only one piece per delivery point per day in 2020 compared to about 2.5 pieces in 2000.[36] That piece will only contribute 40 cents of the revenue needed to cover the cost of the delivery point or a 43 percent decline from 2009 to 2020.[37] See Table 5 below.

Table 5: First-Class Mail Support of Delivery Network

	2000	2009	2020
Daily First-Class Mail Pieces per Delivery Point	2.5	1.8	1.0
Daily First-Class Mail Revenue per Delivery Point (inflation-adjusted)	$1.00	$0.70	$0.40
First-Class Mail Share of Daily Revenue	56%	50%	40%

Source: Boston Consulting Group, "Projecting U.S. Mail Volumes to 2020," March 2, 2010, p. 12.

With the major revenue stream in jeopardy, the Postal Service could extract further value from the core business by exploring these strategic avenues: revenue assurance, pricing enhancements, as well as marketing and product development.

Revenue Assurance

Revenue assurance includes activities or processes that prevent or detect revenue leakage and ensure all postage is collected. Although a perennial concern, revenue collection becomes increasingly critical to survival as mail volumes decline.

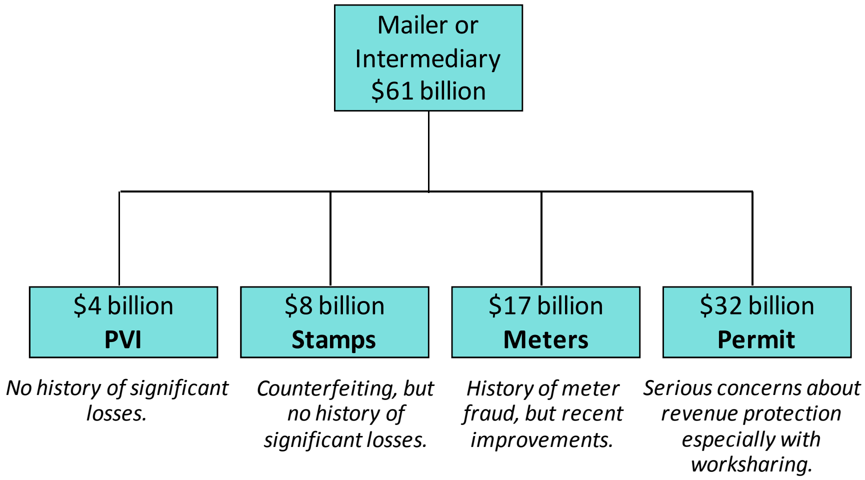
Revenue Loss

Customers purchase postage in a number of ways. Figure 7 presents entry points for domestic mail revenue and potential risk areas.[38] While the Postal Service collects the majority of postage it is due, some mail enters the system without payment or with incorrect payment. Previous work by the Government Accountability Office (GAO) and the Office of the Inspector General (OIG) cited inadequate policies, procedures, and training related to collecting postage as well as improperly conducted sampling and discount verifications at Bulk Mail Entry Units (BMEU) and drop ship locations.[39] The

[36] Boston Consulting Group, *Projecting U.S. Mail Volumes to 2020*, March 2, 2010, http://about.usps.com/future-postal-service/gcg-narrative.pdf, p. 12.
[37] Ibid.
[38] Appendix A explains postage payment methods.
[39] For example, U.S. Postal Service Office of Inspector General, *Short Paid Postage – Information Based Indicia (IBI) Priority Mail,* Report Number MS-AR-09-001, October 10, 2008 and *Short Paid Postage – Information Based Indicia (IBI) Parcel Post*, Report Number MS-AR-09-002, October 14, 2008, and U.S. Government Accounting Office, *Stronger Mail Acceptance Controls Could Help Prevent Revenue Losses,* Report No. GGD-96-120, June 1996.

OIG also found mail-processing equipment that was unable to identify FCM with missing or insufficient postage and fraudulent indicia.[40]

Figure 7: Domestic Mail Revenue by Entry Point, FY 2010



Source: FY 2010 Quarterly Statistics Reports and OIG analysis.

Pricing Enhancements

The Postal Service has a number of pricing options available within the existing legal framework to help fill the revenue gap associated with a projected volume decline of 27 billion pieces from 2009 to 2020.[41] Protecting FCM profit contribution while managing the decline, solidifying market dominant product cost coverage, exploring competitive pricing best practices, and pursuing simplification opportunities are all strategies that can have a significant impact on promoting profit contribution.

FCM Pricing: Do No Harm

Postal Service pricing and forecasting models utilize key data such as population and employment growth to identify and predict changes in mail volume. Even under the best-case scenario, FCM is not expected to return to its peak volumes.[42] To adjust to a smaller FCM footprint, the Postal Service should manage profits, not volumes. There is tremendous revenue potential in the remaining volume, and capturing this intrinsic value is a common business practice. Pricing strategies should segment customers and enhance the value of FCM to distinct groups.

[40] The OIG's current audit project, set for release in fall 2011, *Strategic Approaches to Revenue Protection* (11RG011MS000), focuses on commercial volume revenue loss. The objective is to evaluate the Postal Service's revenue protection strategies, identify opportunities for revenue leakage, and suggest potential risk-mitigating solutions.
[41] The Boston Consulting Group, *Projecting U.S. Mail Volumes to 2020*, March 2, 2010, http://about.usps.com/future-postal-service/gcg-narrative.pdf, p. 2.
[42] Ibid.

Measuring the price sensitivity of discrete FCM business segments is a critical priority. Current estimates suggest that FCM is price inelastic and that recent volume declines are not related to price. Therefore, it is likely that FCM could weather higher prices. Alternatively, sales promotions designed to persuade mailers to avoid electronic alternatives through discounts could fail to bring in additional volume, damage profits, and lessen the perceived value of FCM.

Market Dominant: Product Cost Coverage

Increasing prices for market dominant products not covering their costs would improve contribution and could shift volume to products that are profitable. If the Postal Service raised rates to breakeven levels on all 10 money-losing market dominant products in 2010, the associated revenue increase could have been over $1.6 billion.[43] The Postal Service has taken some actions to address costs for these products. For example, on July 1, 2010, the Postal Service implemented streamlined flat processing that could cut losses for Periodicals by one-third.[44] However, as profitable FCM volumes continue to decline, raising prices may be essential for financial viability, as cost savings alone cannot offset the decrease in profit contribution.

Simplified Pricing

Attracting new mailers is essential to encourage organic revenue growth, and the success of the Priority Mail Flat Rate Box demonstrates that simplified pricing can generate new revenue streams. The new Standard Mail simplified address product named Every Door Direct Mail also seems to be attracting new users of the mail.[45] Streamlining standards, products, and pricing structures allows many small to medium sized mailers direct access to the benefits of commercial mailing without the need to purchase expensive software or work through a third-party provider. Moreover, ease-of-use paired with economical prices could help raise volume particularly from those not currently using the mail. Standardizing and streamlining mailing standards regulations, re-engineering induction processes, and simplifying complex rate design could help increase revenue.

Value-based Pricing

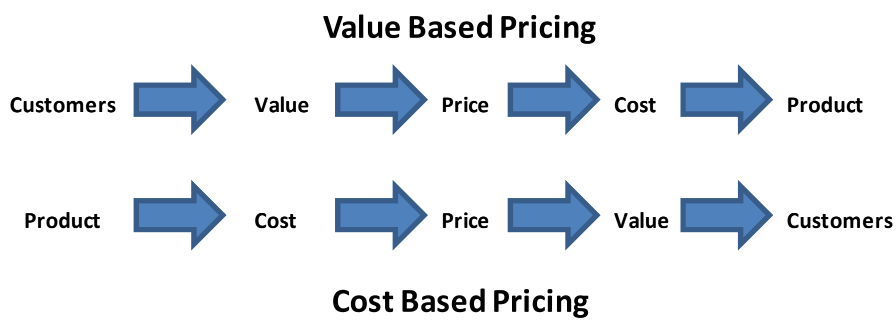
Developing robust pricing capabilities will help promote profitable products. Legacy cost-based prices, which carried over after PAEA legislative changes, resulted from the application of a mark-up on top of product-specific and allocated network costs. The past reliance on cost data for the basis of prices limits the Postal Service from pricing products based on consumer demand or willingness to pay. Competitors employ a value-based pricing methodology to develop a target price that reflects the worth of the

---

[43] U.S. Postal Service. Cost and Revenue Analysis (CRA), FY 2010. See Appendix B for details.
[44] "An end to the Postal Service's Wall Street Journal subsidy?" *Dead Tree Edition*, June 21, 2011. http://deadtreeedition.blogspot.com/2011/06/end-to-postal-services-wall-street.html.
[45] Alan Robinson, "Every Door Direct Mail - How it is Being Used", *Courier, Express, and Postal Observer*, August 31, 2011, http://courierexpressandpostal.blogspot.com/2011_08_01_archive.html.

product to customers. Figure 8 highlights the differences between value-based and cost-based pricing.[46]

Figure 8: Value-Based Versus Cost-Based Pricing



Source: "Pricing Innovation for a Transitioning Postal Service Administration," in *Competitive Transformation of the Postal and Delivery Sector*.

In a cost-based pricing scenario, a firm calculates all the corresponding component costs related to a product and then applies a margin to propose a total price. In a value-based methodology, a firm first conducts research to determine a customer's business need as well as the value of the product or willingness to pay. Once the value is determined, a firm can decide if it can profitably offer the product at that price. If not, the firm can either attempt to decrease costs or choose not to offer the product.

Similarly, competitors raise prices related to rising costs when customers are willing to pay. For example, in addition to base rate increases of 6.9 percent on Next Day Air, 2nd Day Air, and 3 Day Select and 4.9 percent on Ground from 2009 to 2010,[47] UPS had fuel surcharge increases, as shown in Table 5, in addition to residential and other ZIP code-based surcharges. UPS successfully mitigated input cost fluctuation risk by determining consumers' willingness to pay and passing along the associated costs.

Table 6: UPS Fuel Surcharges, FY 2008 to FY 2010

	Year End		
Product	**2010**	**2009**	**2008**
Next Day Air/Deferred	8.0%	4.0%	25.2%
Ground	5.6%	3.3%	8.0%

Source: United Parcel Service 2010 Annual Report, p. 26.

[46] Mohammad Adra, Ali Ayub, Charles Crum, Michael Plunkett, "Pricing Innovation for a Transitioning Postal Service Administration," in *Competitive Transformation of the Postal and Delivery Sector*, edited by M.A. Crew and P.R. Kleindorfer (Kluwer Academic Publishers, 2003), p. 375.
[47] United Parcel Service, *2010 Annual Report*, http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9ODUzODd8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1, p. 26.

Conversely, the Postal Service did not implement a rate increase on market dominant products and only a 4.5 percent increase on Express Mail and 3.3 percent on Priority Mail while maintaining a no surcharge policy.[48] Yet the Postal Service is vulnerable to at least the same input cost fluctuations. It estimates that a 1 percent increase in fuel cost will result in $23 million in additional expense.[49] Market research and data collection may reveal that although consumers vocalize opposition to fuel surcharges and other additional fees, they are actually an acceptable way to hedge such risks and protect revenue. Just as airlines implemented baggage fees, once considered unimaginable, they are now the industry norm despite initial strong and vocal opposition.[50]

Marketing and Product Development Opportunities

As traditional sources of revenue decline in an increasingly digital world, new prospects emerge. However, PAEA is actually more restrictive than the previous law in allowing the Postal Service to develop new and improved products and services. Modest flexibility is required to take advantage of emerging opportunities and secure a share of growing markets. For example, the financial crisis fueled a contraction in the global parcel trade, but analysts indicate that cross-border e-commerce will grow dramatically and rebound with consumer confidence.[51] The Postal Service could pursue new uses of mail and develop linkages to the traditional business to keep mail relevant.

International Mail Offers Growth Potential

Although a relatively small portion of the Postal Service's business, revenues from International totaled approximately $2.4 billion in FY 2010.[52] Analysts project that global Internet sales will reach about $489 billion in 2012, compared with $315 billion in 2009, making this an opportunity for growth; however, 70 percent of these sales will originate outside the United States, as only half of domestic retailers currently have global-scale Internet capabilities.[53] Providers who can create customized solutions that help shippers navigate the complicated international marketplace will attract new business. So far, the Postal Service has successfully enacted comprehensive bilateral agreements with foreign posts, developed a small packet or "e-packet" product, and completed numerous Negotiated Service Agreements (NSAs). Consumers will be attracted to providers who deliver superior logistics, returns, security, and authentication services globally. Therefore, the Postal Service has an opportunity to continue developing border-free logistics innovations, such as a cost-effective method for retailers to clear customs and remit duties, taxes, and shipping costs to the appropriate parties, while providing the end consumer with one comprehensive price.

---

[48] U.S. Postal Service, "January 2, 2010 Shipping Services Price Change Frequently Asked Questions," p. 2. http://pe.usps.com/PriceChange/2010_Shipping_Price_Change_FAQ.pdf
[49] U.S. Postal Service, *2010 Annual Report*, http://www.usps.com/financials/_pdf/annual_report_2010.pdf, p. 35.
[50] It is important to recognize that there is often a difference between a customer's stated and revealed price sensitivity. Therefore, customers may find enough value in the product that they will accept higher prices.
[51] International Post Corporation, "IPC Global Industry Report," (Brussels: IPC Markets and Communication, 2010), slide 29.
[52] James Cartledge, "USPS eyes growth opportunities in its global business," *Post & Parcel*, June 20, 2011. http://postandparcel.info/40105/in-depth/usps-eyes-growth-opportunities-in-its-global-business/.
[53] Bob Sechler, "Package shippers eye cross-border ecommerce as key emerging market," *The Wall Street Journal*, May 17, 2011.

Enhance Existing Products

The Postal Service is working toward modifying its current product lines to provide full track and trace, mobile capabilities and other features that create the broad solutions that customers value. Going forward, other core product enhancements provide new opportunities. A 2010 International Postal Corporation (IPC) study highlighted some options for posts to explore, such as increased flexibility for retrieving parcels, improved information management systems that provide real-time visibility to returns, enhanced customer service, and customized e-commerce solutions.[54] Additionally, new marketing programs with compelling value propositions could attract new customers as well as engage existing mailers. The Postal Service should ensure that these new business opportunities do not come at the expense of profit contribution.

Key Account Management

The Postal Service is actively seeking a larger share of the $90 billion national media advertising market.[55] The Mail Works Guarantee promotion taps this revenue potential by giving companies with large advertising budgets incentives to adopt advertising mail. A company spending at least $250 million per year on advertising receives a postage reimbursement if the direct mail campaign results fall short of certain thresholds. Such a guarantee could tempt new mailers to try direct mail while providing huge organic growth prospects for the Postal Service. For example, if a company like General Motors participated and devoted merely an extra 1 percent of its advertising budget to direct mail in 2010, it potentially could have created $51 million dollars in revenue for the Postal Service.[56] However, it is important to note that while revenue is important, the key metric is profit contribution.

Promotions and Negotiated Service Agreements

Under PAEA, the PRC approved pricing initiatives, several experimental product tests, and hundreds of NSAs. The Postal Service can continue to bundle traditional products to generate new revenue streams and enhance cost coverage. However, the revenue generated by these ventures is not sufficient to stem the financial losses resulting from FCM decline.[57]

New Product Development within the Core Business

Table 7 highlights both recent existing initiatives permissible under the current framework as well as likely permissible new ideas presented in previous OIG work.[58]

---

[54] International Post Corporation, "IPC Cross Border E-Commerce Report," slides 34 and 39.
[55] James Cartledge, "Money Back Guarantee for US advertisers to try direct mail," *Post & Parcel,* April 18, 2011. http://postandparcel.info/38225/news/money-back-guarantee-for-us-advertisers-to-try-direct-mail/.
[56] General Motors Company, *Annual Report 2010,* http://investor.gm.com/pdfs/Annual%20Report.pdf, p. 51.
[57] Testimony of Chairman Ruth Y. Goldway, Postal Regulatory Commission, before the U.S. Senate Homeland Security and Governmental Affairs Committee's Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, "Addressing the U.S. Postal Service's Financial Crisis," May 17, 2011.
[58] U.S. Postal Service Office of Inspector General, *The Postal Service Role in the Digital Age Part 1*, Report No. RARC-WP-11-002, http://www.uspsoig.gov/foia_files/RARC-WP-11-002.pdf, *The Postal Service Role in the Digital Age Part 2*, Report No. RARC-WP-11-003, http://www.uspsoig.gov/foia_files/RARC-WP-11-003.pdf, and Revenue Generation Strategic Report, Report No. MS-MA-10-002, http://www.uspsoig.gov/FOIA_files/MS-MA-10-002.pdf.

The latest product proposals and offerings are innovative, yet linked to the Postal Service's core business — raising hopes that opportunities still lie within the existing product lines. Fifteen years ago, no one would have expected a company like Netflix to create an entirely new FCM product, but by FY 2010 it became one of the Postal Service's top customers and generated hundreds of millions in revenue. Yet, there are a number of concerns related to new initiatives as to whether: 1) the new products or services can generate sufficient revenue and profit to address declines in other areas or 2) if they will fit within the legal or political framework that currently exists. PAEA limits a new offering to relate to "the delivery of letters, printed matter, or mailable packages, including acceptance, collection, sorting, transportation, or other functions ancillary thereto".[59] Will potential new opportunities be classified under "ancillary service" provisions or tested as an experimental product?[60] Will the Postal Service be allowed to take advantage of other profitable opportunities for which it is well suited? Many questions remain.

Table 7: Examples of Initiatives Feasible under Current Framework

Product/Service	Description
Sampling	Partnering with marketing firm StartSampling to consolidate the product samples in a box and ship it. The Postal Service collects postage and a fee.
Every Door Direct Mail	Employs a simplified address service for small businesses which waives permit fees and requirements for individual addresses to facilitate local based advertising campaigns. This could offer small businesses a simple, low cost means of distributing advertisements.
Hybrid Mail	Convert digital documents to physical and vice versa for senders and receivers.
Digital Platform	Provide secure transactions and identity verification between customers, businesses, and government entities. Extend the Postal Service's physical platform into the digital realm by enabling traditional service providers and entrepreneurial "applications developers," to generate new physical and digital postal services that meet customers changing needs.
Standard Defined Day & Deferred Delivery w/ Ancillary Services	Bulk printing, online/hybrid printing, and geographic targeting on mail piece and delivery date selection.
Post Office Box/Pack Station	Provide real time notification of delivery and alternative locations for pick up.
Address List Database	Leverage value of address list database for uses such as demographic targeting.

[59] 39 U.S.C §102(5).
[60] The PAEA, Section 203 (codified at 39 USC §3641) describes the conditions necessary for carrying out a market test for experimental products including 1) "significantly different" or novel and 2) cannot create an unfair competitive advantage.

Revenue Possibilities under an Alternative Framework

McKinsey & Company's March 2, 2010, action plan for financial viability outlined a balanced strategy of cost reduction and revenue generation to meet America's changing needs. The plan also highlighted that substantive change beyond cost cutting, easing prefunding requirements, and correcting overpayments to pension funds is necessary for the Postal Service to uphold its mission to bind the nation together in a new era.

Barriers to the Path Forward

If the Postal Service is to capture new sources of revenue in order to continue to operate as a self-funded organization that also meets the needs of the American people, varied stakeholders need to address some fundamental questions. The flexibility to pursue new opportunities will require access to capital, developing new competencies, labor flexibility, diversification of product lines, adjusting the cost structure, and the authority to expand beyond the narrow, hard-copy core.[61] These types of considerations fall into five categories: statutory, regulatory, institutional, political, and financial.

Statutory

Some future possibilities require flexibility not presently permissible in the current law, which:

1. Prevents the Postal Service from offering new nonpostal products and services.
2. Establishes arduous market test requirements in terms of recouping start-up costs and caps projects at a $10 million revenue limit in any one year.[62]
3. Requires full cost recovery within two years to show cost coverage compliance.[63] This amortization timeline is inconsistent with typical start-up projects that often do not break even for many years.
4. Caps prices, by class, at CPI — a measure unrelated to Postal Service costs.

Regulatory

Regulatory burdens come in a number of forms:

1. Although improved, the preparation and review process for pricing and new product approvals puts the Postal Service at a competitive disadvantage in terms of speed to market.
2. Transparency requirements, although prudent, make operating in a competitive marketplace difficult. Successful implementation of new products and services might require speed and confidentiality first and transparency second.

---

[61] Accenture, *Is Diversification the Answer to Mail Woes? The Experience of International Posts*, February 2010, http://about.usps.com/future-postal-service/accenture-presentation.pdf.
[62] James Cartledge, "USPS needs 'incubation space' to address digital challenge," *Post & Parcel.* June 17, 2011. http://postandparcel.info/40050/news/usps-needs-incubation-space-to-address-digital-challenge/. Exception authority details are noted in PAEA, Section 203 (codified at 39 U.S.C. §3641), if revenues do not exceed $50 million in any one year if "(A) the product likely to benefit the public and meet an expected demand; (B) the product likely to contribute to the financial stability of the Postal Service; and (C) the product is not likely to result in unfair or otherwise inappropriate competition."
[63] The PAEA, Section 203 (codified at 39 U.S.C. §3641).

3. Some stakeholders voice concerns about the appropriateness of the Postal Service operating in new arenas.

Institutional

The Postal Service faces unique internal challenges as well:

1. Existing skills and competencies in mail do not necessarily provide synergies or the capabilities necessary to compete in new business areas including the digital space.[64]
2. Long time horizons and acquisitions may be necessary to develop requisite competencies.[65]
3. A crucial component to successful new ventures is a corporate culture that embraces experimentation, even at the risk of early failure.[66] Sustaining a management commitment and strategic vision beyond traditional mail business is essential as well.

Political

The political environment also challenges efforts to define the future role for the Postal Service:

1. Motivated and well-organized opponents to new product introductions and entrance into new sectors.
2. Many stakeholders with varied interests as well as uncertain support in congressional and PRC proceedings.
3. Competing policy considerations about proper revenue opportunities and the role for the Postal Service.
4. Strong opposition to price increases, which differs from comparative, anecdotal, and economic measures of customer response.

Financial

Regardless of the source of the Postal Service's financial difficulties, these financial constraints currently limit the Postal Service's options:

1. The Postal Service lacks the operating capital to invest in both revenue generating and cost reducing initiatives.

The resolution to these considerations is best developed by policymakers and the Postal Service, and is outside the scope of this paper. The Postal Service can continue to cut costs, right size its network, and foster new revenue sources within the existing framework; however, decisions will be necessary in order for the Postal Service to explore new options to remain financially viable.

---

[64] Accenture. Is Diversification the Answer to Mail Woes? The Experience of International Posts, February 2010, http://about.usps.com/future-postal-service/accenture-presentation.pdf, slide 32.
[65] Ibid.
[66] "How Failure Breeds Success," *Bloomberg Businessweek*, July 10, 2006. http://www.businessweek.com/magazine/content/06_28/b3992001.htm

Possibilities under an Alternative Framework

Two levers of revenue generation potential, outside the current legislative framework, are pricing as well as diversification into new products, services, and sectors.

Pricing: A Strategic Asset

The 2006 PAEA legislation did not anticipate recent volume declines or understand the impact of the large prefunding mandates, and so introduced a pricing restriction that capped market dominant price increases to the Consumer Price Index (CPI) by class.[67] Under the current price cap, the Postal Service lacks the practical flexibility or the will to make adjustments to permit revenue to cover costs. Permitting modifications to the CPI-based price cap could allow the Postal Service to pay for existing unfunded mandates and deal with future external shocks outside the control of management. One approach is to apply the cap across all market dominant products, rather than by class. Another approach could be to move Standard Mail (which is part of an active advertising market) into the competitive category. Refinements to the cap can also continue to incentivize efficient management of the Postal Service and its physical networks in particular. Permitting the regulator to adjust the price cap to better match Postal Service expenses, as opposed to a generic measurement of inflation, could also help to address the issue of the gap between revenues and costs.

Faced with a mature, declining core business, and with growth areas such as parcels, which are presumably not large enough to compensate for the decline, the Postal Service could benefit from a more business-like approach to pricing. Even if deemed technically permissible under PAEA, such a change would be extremely difficult to implement in the current context. By reclassifying its products and raising some prices while lowering others, the Postal Service could mirror successful private-sector approaches and get all the revenue it can from no-growth mature products while encouraging the growth of other areas through discounts. An attractive target for price increases would be segments with low price elasticities, which suggests modest price changes would have relatively minor effects on volume. The inverse is true for segments with higher price elasticities, where customers would be more likely to respond to price decreases with additional volume.[68]

New market research could help fine-tune segments to simultaneously meet customer needs and generate revenue. The Postal Service could consider widening the gap between FCM and Standard Mail pricing and service to stave off substitution and protect margins. FCM prices at 50 cents, 75 cents, or even well over $1 have been successful in other postal markets and could provide an example for the Postal Service to follow. In fact, the current FCM Single-Piece rate in the United States is only a little over one-third the average rate within the European Union.[69] The Postal Service is

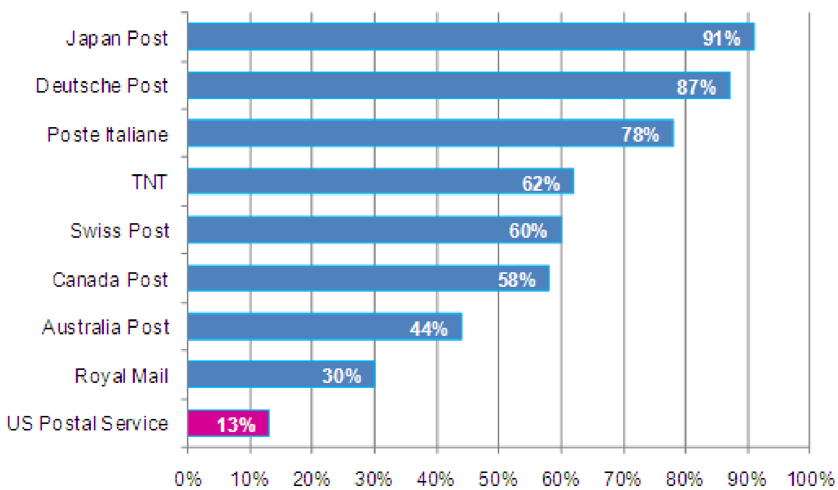
[67] McKinsey & Company, *USPS Future Business Model*, March 2, 2010, http://about.usps.com/future-postal-service/mckinsey-usps-future-bus-model2.pdf, slide 4.
[68] It is important to note that none of the major mail categories are technically "price elastic" — meaning that a price decrease would result in increased revenue.
[69] Please see Appendix C for a comparison between prices within the European Union and U.S. Postal Service FCM prices.

currently constrained in its pricing authority, but solid market research and business analytics could lay the foundation for adjusting current limits that keep its rates disconnected from the rest of the industrialized world.

Diversification: New Sectors, Products & Services

In order to address structural problems like decreased relevance, liberalization, and the resulting rise in USO costs, international posts pursued a broad range of diversification opportunities outside of traditional mail that provide significant financial benefits.[70] Many of these posts are consistently profitable even in the face of volume declines in traditional services. The Postal Service is in an unfavorable position due to an undiversified portfolio, which increases exposure to financial risks caused by declining mail volumes. Figure 9 below shows the proportion of non-mail revenue generated by the world's major industrialized posts.[71]

Figure 9: Proportion of Non-Mail Revenue, by Post



Source: Accenture, "Diversification of International Posts," February 2010.

It is important to note the dramatic difference in the proportion of revenue collected from non-mail products between the U.S. Postal Service and major foreign posts. The gap is large and has been growing. The collective non-mail revenue at foreign posts grew from 49 percent in 2003 to 63 percent in 2008. In fact, non-mail revenue accounted for revenue growth of more than 100 percent at foreign posts between 2003 and 2008.[72] Notably, logistics, retail, and banking services provided substantial non-mail revenue diversification opportunities.[73]

[70] Accenture, *Is Diversification the Answer to Mail Woes? The Experience of International Posts*, February 2010, http://about.usps.com/future-postal-service/accenture-presentation.pdf, slide 27.
[71] In FY 2011, this figure was 15 percent for the U.S. Postal Service. Accenture, *Is Diversification the Answer to Mail Woes? The Experience of International Posts*, February 2010, http://about.usps.com/future-postal-service/accenture-presentation.pdf, slide 40.
[72] Ibid., slide 27. Note that some of the posts with the highest proportion of non-mail revenue (such as Japan Post) are engaged in lucrative insurance and banking businesses.
[73] Ibid.

Diversification, however, is not without risk. Success requires resources to develop new capabilities and the time to foster profitable new businesses without regulatory pressure to produce results immediately. Regardless of the long term value of developing new areas, it will take time to see significant results. Moreover, it would likely require new thinking, training, personnel, business partners, and perhaps significant changes to the core business model. Not all opportunities explored by foreign posts make sense with the Postal Service's core strengths and mandate and many require financial investment resources the Postal Service currently lacks. Yet, the time to evaluate these new revenue sources is now, as the Postal Service's financial health is inextricably tied to the hard-copy mail market, which is profitable but also perceived to be in general decline.

As the OIG has advocated, ancillary services can link the digital and physical world.[74] In particular, the development of a secure eMailbox that serves as a digital counterpart to the physical mailbox and links to one's physical address would serve as a foundation for a full spectrum of potential products and services. From identity authentication and the expansion of eGovernment services to hybrid and reverse hybrid applications to enhanced eCommerce and on-line applications, the Postal Service would be well positioned to reach every household and business both physically and digitally. And by partnering with the private sector, such new products and services would leverage external innovation and expertise with the Postal Service's core assets such as its reach into every household, address management system, and extensive retail network.

Conclusion

This paper presents options to protect and grow existing revenue sources and drive profitable growth within the existing framework. Ultimately, the Postal Service cannot focus on cost cutting alone. It must both cut costs to meet its new footprint and utilize the flexibility it has to raise revenues in order to maintain its mission to provide universal service to the American people. Although some note that the returns on investment on new endeavors may be less than that for FCM, like similar organizations, the Postal Service will need to look for revenue growth opportunities both within and beyond its declining traditional business. It will also need to evolve and adapt to the communications revolution and meet the changing needs of the people that it was created to serve. Disruptive innovation, such as that underway in the communications sphere, requires significant change and the support of varied stakeholders.[75] At least some agreement by these parties will be necessary to give the Postal Service the flexibility it needs to pursue new options and move beyond the critical crossroad it faces today. Although change implies risk, the greater risk is waiting until it is too late and destroying an important institution that can still be saved.

[74] U.S. Postal Service Office of Inspector General, *The Postal Service Role in the Digital Age Part 2*, Report No. RARC-WP-11-003, April 19, 2011, www.uspsoig.gov/foia_files/RARC-WP-11-003.pdf.
[75] Don McCrae, "Miss the Big Picture, Fade Like Polaroid," *Bloomberg Business Week*, October 23, 2002, http://www.businessweek.com/careers/content/oct2002/ca20021023_9615.htm.

Appendices

Appendix A Postage Payment Methods

PVI – Postal Service window clerks apply Postage Validation Imprinter (PVI) labels to mail pieces at post offices after payment is provided by the customer. Pieces are then directly inducted into the postal network. This method is used primarily by individuals and very small businesses.

Stamps – Customers can purchase stamps at a variety of locations (Post Offices, USPS.com, third-party distribution sites) and apply postage directly to their mail pieces by hand. They can then deposit the pieces in collection boxes, in their own mail boxes, or at post offices. This method is used primarily by individuals, though some large customers use stamps (regular or precanceled) and deposit their mail pieces at bulk entry locations. With precanceled stamps, mailers generally must pay (or be refunded) the difference between the implied stamp value and the actual postage cost to the Postal Service at the time of bulk entry.

Meter – Customers who have meters can apply postage directly to their mail pieces or onto a meter tape that is applied to the mail piece. Postage is prepaid and entered into the meter. Meters range from very small and hand fed to very large and automated. Mailers can deposit their pieces in collection boxes, at post offices, or bulk entry locations. This method is used primarily by small and medium-sized business mailers.

Permit – Permit Imprint is the most common way to pay for postage, particularly for large mailings. The mailer generally prints postage-related information in the upper right-hand corner of the mail piece. All Permit mail is bulk entered and includes a postage statement that describes the mail type and volume. Postage value is deducted from the mailer's prepaid Permit account when it is accepted and inducted into the postal system.

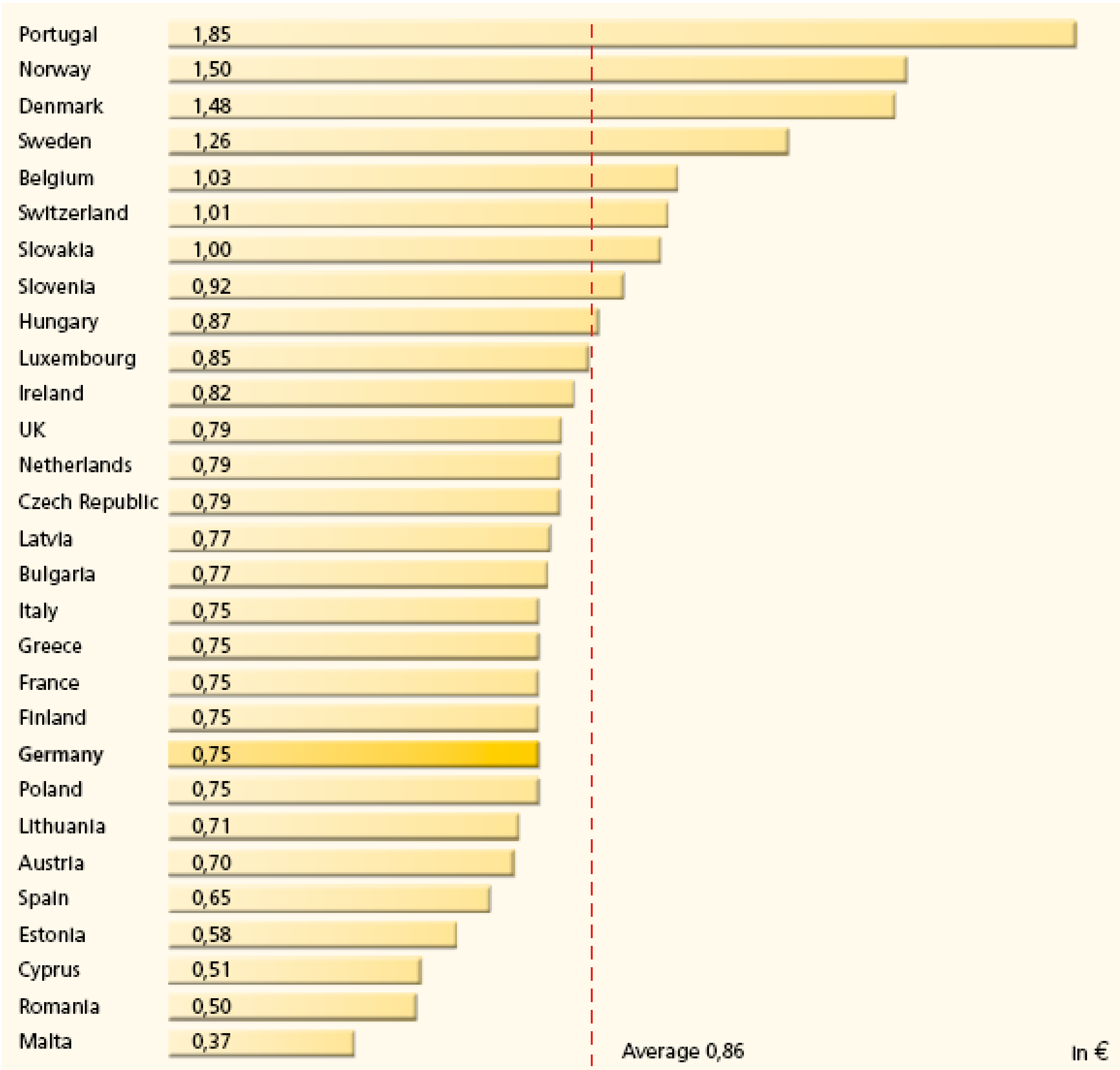
Appendix B Market Dominant Money Losing Products 2010

Market Dominant Mail Classes and Products	Cost Coverage	Contribution Per Piece	Volume in Pieces	Lost Contribution
First-Class Mail:				
Parcels	99.89%	(0.002)	574,428,826	($1,237,417)
Inbound International Single-Piece Letter Post	79.33%	(0.154)	346,070,796	(53,293,915)
Standard Mail:				
Flats	81.59%	(0.083)	7,049,230,266	(581,963,599)
Not Flat-Machinables and Parcels	77.20%	(0.261)	682,403,363	(177,838,055)
Periodicals:				
In County	74.23%	(0.036)	695,455,322	(25,382,122)
Outside County	74.99%	(0.091)	6,574,014,264	(598,041,072)
Package Services:				
Single-Piece Parcel Post	82.12%	(2.181)	61,408,341	(133,931,773)
Bound Printed Matter Parcels	92.07%	(0.113)	229,751,608	(25,989,786)
Media and Library Mail	80.42%	(0.734)	122,322,100	(89,784,940)
Ancillary Services:				
COD	79.10%	(2.066)	834,483	(1,723,733)
TOTAL				($1,689,186,411)

Note: This does not account for the expected volume decrease in response to price increases.

Source: U.S. Postal Service, Cost and Revenue Analysis (CRA), FY 2010.

Appendix C Nominal Prices for Letter Mail within Europe



Note: The prices are in Euros and are for the 3-day rate within Europe. Utilizing a September 2011 exchange rate, results in a price range from $0.50 in Malta to $2.49 in Portugal. The comparable price within the United States is $0.44 or a little over one-third the average price within Europe. Note that this does not match the intra-country prices charged by these countries. For a comparison to large, intra-country prices outside of Europe, note that both Canada (including VAT) and Australia charge an equivalent rate of approximately USD $0.64 or 20 cents more per piece than the current U.S. Postal Service price.

Source: Deutsche Post, *Letter Prices in Europe Up-to-date international letter price survey*, March 2011, p. 11.