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Stuart J. Sweet, President **June 2, 2004**

$900 BILLION IS IN THE MAIL

For nine million Americans, "going postal" makes them happy. According to the Mailing Industry Task Force headed by a Deputy Postmaster General and the CEO of Pitney Bowes, that is the number of American workers who earn a living because people send letters and packages. The envelopes you open today, and the letters they contain, are made from paper that was produced by companies that harvested trees, transported those trees to mills, transformed their pulp into individual envelopes and sheets, sent them to wholesalers who then sold them to printers. The printers, in turn, were under contract to prepare copy designed by the creative designers from stationers, advertising companies, or invoice preparers. These documents then had to be folded, stuffed, sealed, and appropriate postage applied to them. They were then transported to postal centers where they were sorted, loaded on planes or trucks, and finally walked up to your door and placed in your mail box.

The tip of the spear for this $900 industry is the post office and its 738,000 career employees. Unfortunately for those who work in the industry, or rely on it to market or distribute their goods and services, the tip is losing its edge, and the spear's wood is rotting. While the Postmaster General has his sharpening stone out and Congress is applying duct tape, the spear is going to crumble.

Here are several publicly-traded companies affected by postal developments. They have joined the "Coalition For a 21st Century Postal Service," a 156-member consortium that is lobbying Congress to keep postal prices down.

Known Publicly-Held Postal Reform Stakeholders

Printers:	Donnelley & Sons (RRD), MeadWestvaco (MWV), Quebecor World (IQW), Mail-Well (MWL)
Mailing Services:	Pitney Bowes (PBI), DSTSystems (DST), Deluxe Corp (DLX)
Paper:	International Paper (IP)
Magazines:	Time Warner(TWX), Meredith (MDP), Primedia (PRM), Playboy (PLA)
Direct Mailers:	Acxiom (ACXM), Harte-Hanks, Inc (HHS), ADVO (AD)
Heavy Users:	American Express (AXP), Capital One Financial (COF), Time Warner (TWX)

Coalition members are keeping their eyes on Capitol Hill this week. Following the lead of the House Government Reform Committee, the Senate Governmental Affairs Committee just passed legislation which is intended to keep the U.S. Post Office in the black. Will it work?

<u>The President's Commission on the United States Postal Service</u>

On July 31, 2003, a Commission created by President Bush reported its findings on the future of the postal service. Indirectly, Commission experts also told investors in this $900 billion what to expect in the future. In a country with 25 percent more people, and a real GDP more than 50 percent higher in 2017 than in 2002, they expect a 10 percent *decline* in volume. This bearish projection may prove optimistic. Despite the recovery, volume in 2003 went down to 202.2 billion. **For investors, this is a $900 billion industry with "return to sender" stamped on large parts of it.** Those in the business of providing complementary products have a stagnant future; those providing competing products may prosper, capturing more future postal business.

Gradual Displacement of Mail Volume (billions)

	2002	**2007**	**2012**	**2017**
First Class	102.4	98.7	90.5	81.0
Priority	1.0	1.1	1.2	1.3
Periodicals	9.7	9.5	9.1	8.7
Standard Mail	87.2	97.1	98.2	88.1
Package Service	1.1	1.1	1.1	1.2
International	0.9	0.9	0.9	0.9
Other government	0.5	0.5	0.5	0.5
Total	**202.8**	**208.9**	**201.5**	**181.7**

<u>Blame it on the Internet</u>

For more than two centuries, the U. S. Postal Service (USPS) has operated a monopoly. If you wanted to send a hand-written or typed message, you had only one legal method for doing so – buying first class postage. Due to this government-sponsored monopoly on first-class mail, the postal service can generate 68 percent of its total margins from 48 percent of its volume. Unfortunately for the USPS, the Internet and fax machines, now offer legal ways around their 225 year-old monopoly. From 2002 to 2003 alone, first class mail volume fell by 3 billion pieces, or 3 percent.

The rise of email is eating into first class postal volume – a trend expected to escalate as electronic billing and bill paying become increasingly popular. Already, twenty-five percent of households use electronic banking to pay some bills. However, bill presentment has yet to take off, with only 2 percent of households accepting electronic invoices. Businesses will press ahead, since processing e-bills costs one-third to one-half less than mailed bills. The financial consequences of this future are clear for the USPS; first class mailing enjoys a 88 percent mark-up while the mark-up for " standard mail," mostly advertising which is growing in volume, produces a mark-up of only 48 percent. In 2002, gross margins on periodicals, such as newspapers and magazines, were a negative two cents per item delivered. After allocating overhead, probably only the first-class mail monopoly is profitable. The economics of all mail products is discussed at http://www.prc.gov/docs/37/37466/cra-draft.pdf.pdf . For a micro look at mailing rates for first class, periodical, or standard mail, turn to http://dbcalc.usps.gov/iePE.htm.

There is more trouble. Despite falling first-class mail volume, the number of addresses that the postal service must deliver to six times a week rose to 141 million, up by more than 5 million over the last three years, as the number of American households and businesses grew. USPS management faces extra challenges in meeting new delivery demands with an overpaid unionized workforce. Total annual compensation of postal clerks and letter carriers, including pay and benefits, averages almost $60,000. As a result, personnel costs approximate 80 percent of operating costs, compared to about 40 percent for Federal Express and 55 percent for UPS. Adding to its woes, the USPS has a combined debt and unfunded liability of $90 billion, due to projected retiree pension and medical care expenses. The problem hits soon because its aging workforce will retire early due to the physically demanding nature of postal work.

Consistent with its deteriorating performance, the Comptroller General of the United States, David Walker, who heads the Government Accounting Office, reported to Congress on April 4, 2001 that he has added the USPS to his "High-Risk List."

Congressional Duct Tape

Congress can do little to alter the fortunes of the Postal Service. As first-class mail volume drifts downward, it is tempting to try to maintain postal service total gross margins by letting the Postal Commission raise first class postal rates. Existing gross margins are barely sufficient to cover overhead costs now, even when future retirement costs are not included. Such rate increases risk accelerating the use of the Internet to communicate with customers, businesses, and friends instead of the USPS. This will create an even faster long-term "death spiral"as corporate mail users are incented to invest in alternative ways of reaching customers.

This could happen, even if it does long-term damage. The next postal increase is expected to become effective on January 1, 2006, and observers expect that a first class stamp will jump by more than 10 percent, from 37 cents to 41 cents. This follows a boost on June 30, 2002 from 34 cents to the present 37 cents. Just as the sale of baseballs will decline if the prices of baseball bats and gloves leap, a drop in mail volume means falling sales for products that complement postal delivery – those of paper makers, envelope manufacturers, printers, direct mailers, newspaper and magazine publishers, also fall if first-class postage goes up. Over the long run, expect some catalogers and magazine publishers to be hit hard. According to congressional witnesses, postage costs of some catalogers and magazine publishers now exceed fifty percent of total costs. For some newspapers, it already equals 20 percent.

Two other long-term ideas suggest how to slow the death spiral. The first is to cut carrier labor costs by giving up on Saturday deliveries. The second is to give up on the Postal Service paying for itself. For most of its history, the USPS has run deficits, averaging 20 percent of revenue. Taxpayers have made up the difference.

A Win for FedEx and UPS

Proposed reforms chip away at the Postal Service's first-class monopoly. Under the House Committee bill, private companies could offer non-urgent service if they deliver letters that weigh more than 12.5 ounces, provided they charge more than six times the cost of a first class stamp for doing so. It doesn't sound like much, and indeed, the European Union is moving toward a 1.8 ounce and 2.5 times first-class rates as their privatization standard. Still, when FedEx and UPS can compete with the Postal Service, they win. The Post Office's Express Mail product captures only 6 percent of the "urgent mail" market. Similarly, the Parcel Post Service handles only one-fourth of all package deliveries. Still, there is a long way to go. FedEx annual volume equals only two days of Postal Service volume. For UPS, the figure is just one day. FedEx and UPS also like statutory language forbidding the Service from using profits from its first-class monopoly to cross-subsidize delivery of urgent mail and packages.

Legislative Prospects: Passage This Year is Likely

Congressional leaders in charge of overseeing the postal service are aware of the long-term death spiral and have produced a modest bill that all postal stakeholders support. On May 12, 2004 the House Government Reform Committee passed H.R. 4341, the Postal Accountability and Enhancement Act by a vote of 40 to 0. To take pressure off of long-term postal rates, and quiet calls to cut postal worker pay, the bill shifts $27 billion in unfunded retirement liabilities back to the Treasury Department. The 21st Century Coalition likes this move because it lowers its expected future costs. Another provision, a cap on postage prices, is unlikely to matter. Given that the Postal Service is required to support itself and that labor represents 80 percent of its costs, postage rates can be kept low only if labor costs are kept low. U.S. Postmaster General John Potter is doing his part. Mostly on his watch, postal employment has fallen by 85,000 since 1999 – a reduction of more than 10 percent. Potter has used retirement attrition to achieve lower headcount. He will offer more workers early retirement bonuses in the future. He will have a major opportunity to succeed: 47 percent of postal workers are eligible to retire by 2010. The Coalition has a lot riding on whether he succeeds in cutting costs and boosting productivity.

The Senate Government Affairs Committee unanimously passed a companion bill on June 2 that is very similar to the House bill. With all segments of this $900 billion industry, including postal unions, supporting limited reform and given the wide bipartisan backing shown to date, passage seems likely. The last major hitch may be the White House that may not care for the $27 billion pension giveaway. However, the Bush Administration has yet to veto its first bill. It's not clear why it would start here.

For further analysis or information, contact Capitol Analysts Network, Inc. at:
4405 Bradley Lane
Chevy Chase, Maryland 20815
website: www.capitolanalysts.com
Phone: 301-951-9161
Fax: 301-652-5831
Email: capnet@xecu.net