

TESTIMONY OF
JAMES R. O'BRIEN

ON BEHALF OF
TIME WARNER INC.

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON OVERSIGHT
AND GOVERNMENT REFORM

SUBCOMMITTEE ON FEDERAL WORKFORCE,
POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA

OCTOBER 3, 2007

Thank you Chairman Davis and members of the Federal Workforce, Postal Service, and the District of Columbia Subcommittee for taking the time to explore this issue that is so vital to the future of the publishing industry.

My name is Jim O'Brien and I have been involved with the printing, publishing, and distribution of magazines for more than 35 years. Prior to joining Time Incorporated in 1978, I held positions with R.R. Donnelley & Sons Company, United Parcel Service, and U.S. News & World Report.

During my tenure with Time Inc. I have held a variety of positions in the areas of magazine production, printing plant management, and distribution. I am currently responsible for the delivery of many of the nation's leading magazines including Time, Sports Illustrated, People, Entertainment Weekly, Fortune, and Money.

I am also the former CEO of Publishers Express, an alternative delivery that competed with the Postal Service in the delivery of magazines and catalogs. Under my leadership, Publishers Express grew from a two zip code test in Atlanta to a nationwide network serving 1,000 zip codes in 32 cities.

I am the Chairman of the Association for Postal Commerce (Postcom), former Chairman of the Magazine Publishers of America (MPA) Postal Committee, serves on the Mailers Council Board of Directors, and the MPA Government Affairs Committee.

I have testified before the President's Commission on the Postal Service and been a witness before the Postal Rate Commission in two separate proceedings.

I'm a graduate of the University of Illinois and the Harvard Business School Program for Management Development.

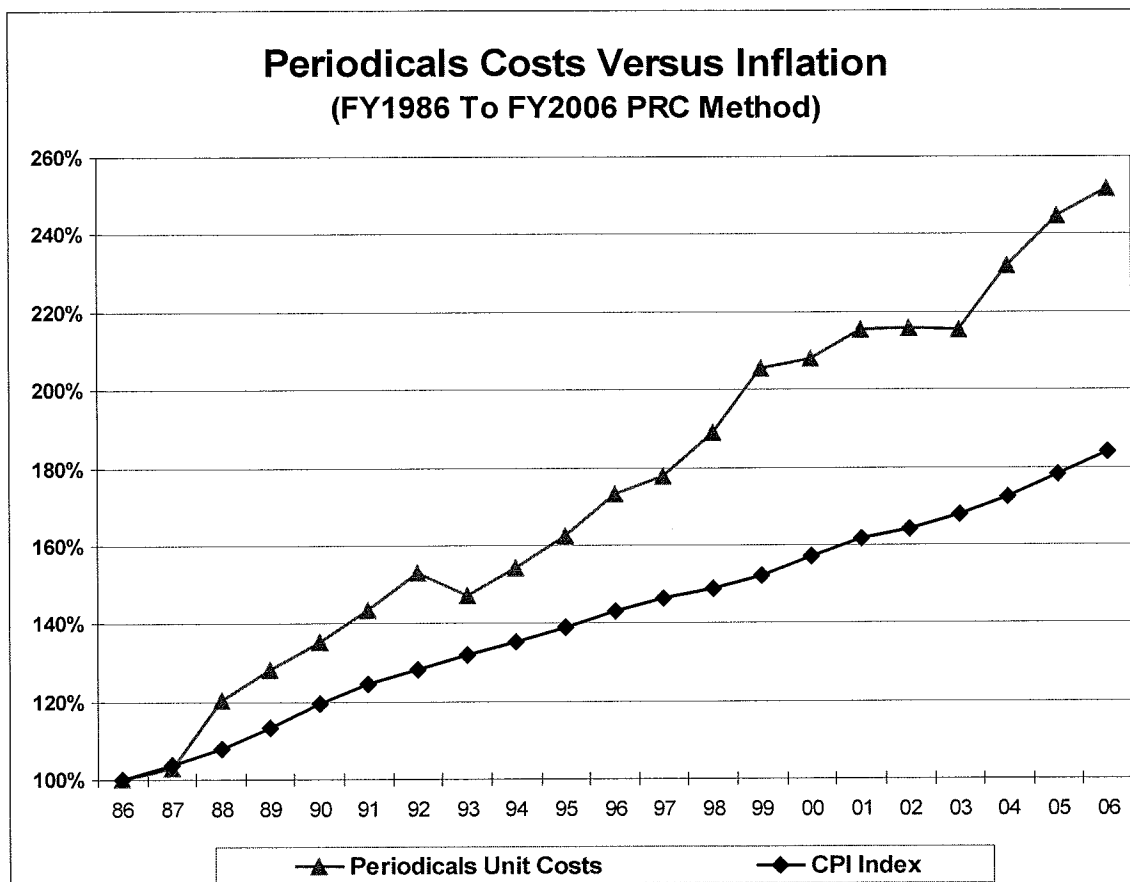
Background

A commonly held misconception throughout the United States is the assumption that the Postal Service is funded by taxpayer dollars. Today, the entire cost of the Postal Service, with the exception of free mail for the blind and overseas voting, is funded by the postage that is paid by mailers. In addition, the law dictates that each class of mail must cover its attributable costs and make a contribution to the institutional costs (overhead) of the Postal Service. In other words, if costs rise for a given class of mail, those costs are borne solely by the mailers within that class.

Traditionally, Periodicals Class mail has received the benefit of providing a small contribution to institutional costs because the law also requires that the rates reflect the "educational, cultural, scientific, and informational (ECSI)" value provided by magazines. Adjusting the contribution to institutional costs was a primary tool for the Rate Commission to recognize the ECSI value of magazines to the American public. As a result, Periodicals Class mail currently contributes approximately 1% to the Postal Service's institutional costs while other classes contribute 50% or more. Historically,

Periodicals contributed as much as 16% to institutional costs but this figure was reduced over the years by the Postal Rate Commission in an effort to offset rapidly rising mail processing costs and the corresponding rate increases. The Periodicals industry has applauded the Rate Commission for their efforts in recognizing ECSI value and protecting magazines from punishing rate increases.

This graph illustrates why the Commission elected to reduce Periodicals' contribution to institutional costs.



As you can see, Periodicals Class costs have outpaced inflation by more than 60% since 1986. The rate of increase became quite severe in 1997 and the Periodicals industry asked the Postal Service to form a joint task force to investigate the causes of the rapidly increasing costs.

In 1998, the USPS Joint Periodicals Operations Review Team was formed. Representatives on the team included the Magazine Publishers of America, American Business Media, publishing companies, printing companies, and the Postal Service. This review team visited a total of seventeen Postal facilities in the fall of 1998. At the conclusion of the process, the team presented a report containing fifteen recommendations (report attached). Recommendation #15 stated that the "Periodicals rate structure should be reviewed to ensure that it is consistent with the overall periodicals processing strategy, and induces appropriate mailer behavior."

Following this report, the industry expected the Postal Service to make progress on this recommendation but no significant changes were made to the rate structure. In 2000, the Postal Service filed a rate case, R2000-1, with the Postal Rate Commission. I provided testimony in this case on behalf of The Alliance of Nonprofit Mailers, American Business Media, The Coalition of Religious Press Associations, Dow Jones & Company, The Magazine Publishers of America, The McGraw Hill Companies, the National Newspaper Association, and Time Warner Inc (testimony attached). In this testimony I discussed the results of the Periodicals Operations Review Team and the need for mailers to “Pay for what they use” (Page 23, line 11). In addition, this testimony contained a rate structure that contains many of the elements adopted by the Postal Rate Commission in R2006-1. It is ironic that some of the very mailers who requested a Congressional hearing in 2007 were the sponsors of my testimony in 2000.

The best way to understand the problems uncovered by the Periodicals Operations Review Team and included in my R2000-1 testimony is by example. Periodicals mail is required to be put into bundles prior to delivery of the mail to the Postal Service. The most efficient bundle is called a carrier route bundle. This type of bundle contains copies that are all going to be delivered by the same letter carrier, and it's designed to travel unopened through the entire postal system until it is finally opened by the letter carrier in a local zip code, such as 60624. If this carrier route bundle is on a 5-digit pallet that enters the Postal system in Chicago, the entire pallet gets transferred to the outbound truck for the 60624 branch. The pallet never leaves the dock area and the only person to touch that pallet is a single fork lift driver.

If the same bundle happens to be on a pallet that contains other bundles for zip codes throughout Chicago, the pallet arrives at the dock and must be taken into the facility where the bundles are sorted on the Automated Package Processing System into containers according to their individual zip code. This machine costs between \$3 - 5 million and is staffed by six to twenty people. Once the bundles have been sorted, a postal employee delivers the container to the outbound truck for zip code 60624.

It's hard to believe, but the old rate structure charged the exact same price for these bundles, even though the amount of processing required and the associated costs are dramatically different. It's clear that the rates did not reflect the actual costs of providing the service. No real business could operate this way, and neither should the Postal Service.

Another example pertains to mail sacks. Depending upon where a sack is entered into the mailstream, it costs the Postal Service between \$1.58 and \$6.23 to process the sack, not counting the costs of transporting, sorting, and delivering the magazines inside. Until last year, sacks could be placed in the mail containing as few as 6 copies of a magazine, which might collectively pay postage as low as \$1.50. In short, the total postage would be less than the handling costs for the sack alone. In other words, the rates were not aligned with the costs. Because the postage rates for Periodicals did not reflect the Postal

Service's costs, and gave mailers little reason to choose more efficient mailing practices, Periodicals costs continued to escalate. Something had to be done to break this pattern.

For this reason, in 2004, Time Warner, Conde Nast, Newsweek, Readers Digest, and TV Guide filed a complaint with the Postal Rate Commission, requesting that it recommend to the Postal Service a rate structure that reflected the costs of processing Periodicals mail. In other words, "Pay for what you use." We proposed that, if the USPS incurred \$1 in cost to process a sack or pallet, the mailer would pay \$1. The Commission elected to hear this case, and from January, 2004 to November, 2005 it conducted proceedings in the full regulatory limelight, including a hearing on the record with the opportunity for all interested parties to present testimony, conduct discovery on other parties and cross-examine their witnesses, and file briefs. After receiving testimony and hearing arguments from all sides, the Commission issued a 235-page Final Order that contained two main conclusions. The first of these was: "progress toward a more cost based rate structure is both possible and necessary."¹ The Commission explained:

It is clear that there is room for improvement in the Periodicals rate structure, especially in light of the new insights that the Complainants provide into the costs of bundles, sacks and pallets. At a minimum, the Time Warner et al. proposal is a more cost-based rate structure than the current structure. If it were fully implemented, it would provide financial incentives to mailers to engage in lower cost mailing practices by encouraging mailers to use more efficient bundling, containerize more efficiently, change to a more efficient zone distribution, and increase the proportion of machinable pieces. . . . The Commission does not view these changes as radical, as some participants contend, because they reflect existing mail preparation practices and mail flows and constitute only partial de-averaging.²

The Commission's second main conclusion was that it was not prepared to recommend adoption of the rate structure that the Complainants had proposed, because the potential rate impact upon some smaller publications was too great. The Commission nonetheless made it unequivocally clear that it expected progress towards the kind of rate structure that we had proposed, and that it expected it in the next general rate proceeding. The Commission's final order stated:

While the Commission is not adopting Complainants' proposal in this proceeding, this result should not be read as a ringing endorsement of the *status quo*. . . . The

¹ Postal Rate Commission, Docket No. C2004-1, Order Addressing Complaint of Time Warner Et Al. (Order No. 1446), issued Oct. 21, 2005, ¶ 1013.

² Order No. 1446, ¶¶ 5003-04.

Commission urges the Postal Service to proceed forthwith to develop a rate design for Periodicals that better serves the needs of all interested stakeholders and thereafter file a request for a recommended decision with the Commission. It is hoped that this Order will further inform the Postal Service and spark prompt action.³

In 2006, the Postal Service filed for a general rate increase, and once again, Time Warner submitted a “cost based rates” proposal. However, in this filing, we substantially modified our previous proposal in an effort to reduce the impact upon smaller, less efficiently prepared publications. We withdrew our earlier proposal's introduction of zoning in the editorial pound rate, and we reduced the portion of costs associated with bundles and containers that we proposed passing through in rates from 100% to only 60%. Once again, the opportunity for a full hearing on the record was afforded to, and fully taken advantage of, by parties who opposed our proposal, and once again the issue that was most extensively litigated was the alleged potential impact of our proposed rate structure on some smaller publications which had become accustomed to paying rates that were far exceeded by what it cost the Postal Service to deliver them. After ten months of hearings, the Commission recommended to the Postal Service a rate structure that was more cost based than the existing structure but that further reduced the potential impact on smaller publications by passing through only 40% of the actual bundle and container costs. As a result of this decision, 60% of these costs continue to be covered by Periodicals Class as a whole and not individual mailers.⁴

Current Status

As a result of the new rate structure, a sea change is taking place within the printing and publishing industry. Publishers who formerly didn't care about how many sacks they were using suddenly have a reason to reduce their sacks and are actively pursuing new mail preparation methods. These changes are being sought by both weekly and monthly publishers with varying levels of circulation. Within Time Incorporated, we are investigating the mailing practices for each of our titles and making changes. We're expanding the number of titles that co-mail, co-palletize, and drop ship. One of our competitors, U.S. News & World Report is co-binding with Info Week to improve their presort levels and create more cost effective mail for the Postal Service.

The changes also affect the printers and logistics companies that produce and distribute Periodicals publications. Large printers like Quebecor World, R.R. Donnelley & Sons, Quad Graphics, and Brown Printing are expanding their co-mail and co-palletization capabilities. The September, 2007 issue of FOLIO magazine contains ads offering co-mailing from smaller printers Ovid Bell Press, Inc. and Sheridan Magazine Services. Would these printers have offered co-mail without a change in the rate structure? Change

³ Order No. 1446, App. B, ¶¶ 28, 13.

⁴ Relevant portions of the Commission's decisions in the R2005-1 and R2006-1 omnibus postal rate cases appended to this testimony.

is taking place very quickly and the reason is that people now have a rate incentive to change their mailing behavior. As we saw during the period from 1998 until 2006, very little change occurs without a rate incentive. If mailers are given the proper price signals, by being held responsible for the costs they impose on the system, they will find ways to become more efficient.

Future

Going forward, I anticipate continued growth in co-mailing, co-palletization, and drop shipping as more printers and publishers respond to the new rates. As a result, I'm hopeful that Periodicals mail processing costs will come back into alignment with the rate of inflation and possibly drop below inflation. This will allow the Periodicals industry and the Postal Service to take full advantage of the Postal Accountability and Enhancement Act and operate within a period of predictable price increases capped by the Consumer Price Index.

In closing, I once again thank the Chairman and Committee Members for providing this opportunity to inform the Committee on the history of Periodicals Class rates and why the current rate structure is critically important to the future of Periodicals Class Mail.

APPENDIX TO TESTIMONY OF JAMES R. O'BRIEN

EXCERPTS FROM POSTAL RATE COMMISSION DECISION
IN THE R2005-1 AND R2006-1 OMNIBUS POSTAL RATE CASES

Docket No. R2005-1, PRC Opinion & Recommended Decision

[The following passages from the Commission's R2005-1 decision show that it is absurd to claim that the Commission's adjustment of the Periodicals rate structure in Docket No. R2006-1 was any kind of reversal of policy or sudden and unforeseeable development.]

[Page ii] The Commission's preference is to develop rates that accurately reward mailers' worksharing. It is concerned that the delay in recognizing the impact of recent innovations and improvements in postal operations, coupled with the passage of time, will probably result in unusually disproportionate increases and decreases in different rates in the next case. The Postal Service and mailers seem prepared for that possibility as they too recognize that proper cost-based rates foster efficiency and promote a healthy postal system.

[On Standard rates]

[5030] On brief, Valpak argues that adoption of the proposed rates may have an unsettling effect in the next rate case since they "would likely exacerbate future instances of rate shock." Valpak Brief at II-13. Apart from the fact that the comment is necessarily speculative, it does highlight a risk that settling parties run, one presumably considered and deemed acceptable. The implicit message appears to be that rate shock should have less weight as a mitigating factor in the next case if it is the result of rate increases *not* adopted in this case.

[5032] Rate shock arguments are often raised in rate proceedings. They are likely to be raised in the next proceeding as well, in which case the Commission will assess their merits based on the record developed in that proceeding. Parties should be aware that the Commission will seek to obtain economically efficient cost-based rates and appropriate allocation of institutional burdens. The discussion of rate design in the following chapter highlights several problematic areas deserving of closer examination in the next proceeding.

[On Periodicals rates]

[6103] *Participants' positions.* Participants in this case representing senders of Periodicals mail include ANM, ABM, CRPA, Dow Jones, The Hearst Corporation, MPA, McGraw-Hill, NNA, NAA, PPA, and Time Warner. Each has signed the Stipulation and Agreement. ANM, Time Warner, and jointly, ABM and McGraw-Hill, filed separate comments or briefs in this case, and Time Warner, along with ABM, Dow Jones, MPA and McGraw-Hill, filed a joint brief as the Periodicals Coalition.

[6104] The Commission recommends, without change, the set of Periodicals Outside County rates and fees identified in the settlement proposal. The recommended rates represent an across-the-board increase; they do not reflect application of traditional rate design methodology. Pound charges, for example, do not reflect the actual distribution of pound miles in the base year. This result carries forward into the test year; thus, in the future, some rate elements may require larger than expected increases to realign rates with costs. Consequently, mailers must stand forewarned that some may face “rate shock” in subsequent proceedings. The Commission recommendations do not include any classification changes consistent with the settlement.

[6122] The Commission notes that the proposed sacking and other changes in Periodicals preparation practices have not emerged in a vacuum; to the contrary, they occur in the much broader context of Docket No. C2004-1, a formal complaint filed by five senders of Periodicals mail prior to the current rate request. The Complaint, in turn, is an outgrowth of concern over escalating cost trends discussed in earlier cases, dissatisfaction with the Postal Service’s progress on promised classification reform, and new insights on cost causation as it relates to the continued efficacy of the longstanding Periodicals rate structure.

Docket No. R2006-1, PRC Opinion & Recommended Decision

[The following passages from the Commission's R2006-1 decision show that it carefully weighed extensive evidence and argument on all the issues raise by FreePress et al., and that it largely rejected their views on the basis of a careful assessment of the factual evidence in that docket, factual evidence that had been accumulating over a series of previous cases, and policy judgments that it has been developing and weighing over a series of cases.]

[5607] Outside County. The record on Outside County reveals virtually unanimous support for structural reform; unchallenged cost studies showing that bundles, sacks and pallets impose costs on the system, independent of those associated with pieces and pounds; the expectation that many lightly-filled sacks will have been eliminated by the test year, given a recent rule change; and more potential for co-mailing and co-palletizing. The Commission recommends adoption of the framework underlying the Time Warner Inc. (Time Warner) proposal in this case and its related costing support, but with significant moderation of passthroughs.

[5608] The proposal in this case differs in significant respects from the proposal Time Warner sponsored, along with others, in Docket No. C2004-1. These differences, especially the elimination of a fully-zoned editorial pound rate, result in substantial moderation of the rate impacts associated with the previous proposal. The Commission recommendation further moderates the Time Warner proposal in this case. Time Warner, while maintaining full support for its proposal as filed, acknowledges that the Commission might find some moderation (or tempering) in order. U.S. News & World Report, Inc. affirmatively suggests that the Commission pursue that approach. U.S. News

Brief at 13.

[5614] The proponents of the three main alternatives are the Postal Service, Time Warner and, acting jointly, the Magazine Publishers of America and the Alliance of Nonprofit Mailers (MPA-ANM). Their proposals differ in direction and degree, but reflect agreement that a more cost-based structure is needed. Other participants voicing opinions on substantive aspects of structural reform concur.

[5615] This consensus is the welcome result of the close scrutiny the Outside County Periodicals structure received in the recent Complaint of Time Warner Inc., et al. and in the ensuing Commission Order. Docket No. C2004-1, Order No. 1446. Indeed, each proponent characterizes its proposal as a response to the Commission's call for measured, but meaningful reform. Other participants addressing the proposals also do so in that context. At the same time, the Commission is pleased that participants have not restricted discussion to the state of Periodicals as of the issuance of Order No. 1446 in October 2005, but have evaluated developments since then and offered considered assessments of the future.

[5712] The Commission finds itself faced with credible, consistent and cumulative testimony that both the container charge and the entire Postal Service package do not send the intended signals to major segments of the class. The Service has not been able to show that the examples provided on this record are isolated or unique instances. Regrettably, the key features of the Service's proposal provide incentives that are so modest that they are, in many instances, outweighed by the elimination of the pallet discounts. In other cases, they are so contradictory that mailers that already engage in efficient practices would not receive appropriate recognition for their efforts. This is clearly contrary to the Service's stated objective of not only incenting new, more efficient behavior, but also recognizing — and continuing to encourage — other mailers' ongoing efficient practices. The Commission concludes that these features of the proposed structure impair the stated objective of proving better price signals and preclude a favorable recommendation.

[5713] Given the conclusion that there are fundamental problems with execution of the Service's objective, the impact arguments ABM and McGraw-Hill offer lose much of their currency. The comparisons flow from a faulty premise; namely, that the structure, in general, is oriented toward providing better price signals.

[5745] The Time Warner proposal uses essentially the same rate design framework as the Complaint case proposal, but incorporates several adjustments intended to moderate impact. This leads most participants to address the proposal in terms of whether those adjustments, considered in light of this evidentiary record, sufficiently mitigate concerns the Commission raised in the Complaint case, including the rate impact on mailers.²⁴¹ US News, a supporter of the Time Warner proposal, contends that they do. It asserts: The

Commission's only criticism of the original Mitchell model in C2004-1 is that it would lead to inordinately high rate increases for some small mailers. Mitchell's current proposal incorporates those concerns, following the same logic as before but softening the impact on certain mailers (and necessarily balancing that by making worksharing incentives less than they were in the C2004-1 proposal. These efforts ... are reasonable U.S. News Brief at 13.

[5746] Opponents generally counter with claims that the proposal is still too much, too soon and still has unacceptable rate impacts. See, for example, ABM-RT-2 at 7. [5747] Assessment in light of an updated record. For all participants except McGraw-Hill, witness Mitchell's decision not to propose a fully zoned editorial pound rate appears to moot the two concerns the Commission expressed in the rate case (undue rate impact on certain small mailers and abridgement of public policy). The Commission has noted its approval of the inclusion of editorial pound rate dropship discounts in its preliminary comments, so that aspect of the Time Warner proposal does not pose a difficulty.²⁴² Mitchell also proposes an editorial discount that is equivalent to the Service's proposed rate and higher than both the existing rate and the rate proposed by MPA-ANM. Therefore, there is continued recognition of the presence of editorial content.

[5748] McGraw-Hill nevertheless contends that the Time Warner proposal undermines the unzoned editorial pound charge because ... non-transportation costs that are nevertheless distance-related would be recovered from 100% editorial publications (as from all other publications) through container charges that (like the zoned advertising pound charges) increase with the distance that a container travels through the postal system. McGraw-Hill Brief at 25-26.

²⁴¹ McGraw-Hill asserts that the Time Warner proposal is at odds with the guidance in Order 1446. McGraw-Hill Brief at 21. The Commission finds this assertion unfounded.

²⁴² McGraw-Hill points out that Time Warner proposes increasing the flat editorial pound charge to a level that is 83 percent of Zones 1 and 2 advertising pound charge. It notes that the traditional level is 75 percent. McGraw-Hill Brief at 25, n.24.

[5749] It notes that origin-entered containers would pay much higher container charges than destination-entered containers under the Time Warner proposal, and concludes that a 100 percent editorial publication would pay substantially more than the unzoned editorial pound charge "for the privilege of making a greater use of Postal Service transportation." Id. at 26. To that extent, McGraw-Hill finds that the purpose of the unzoned editorial pound charge is defeated. Id., McGraw-Hill Reply Brief at 15-17.

[5750] The policy of promoting editorial diversity and widespread dissemination of editorial matter is one of many that must be weighed and balanced. Some of those considerations include recognizing costs and promoting worksharing. The Commission finds that cost-based container charge differentials reflecting dropshipping alternatives can not reasonably be said to defeat the public policy purpose underlying the flat editorial pound charge. It therefore rejects the suggestion that the Time Warner proposal should not be adopted on this ground.