

OUTLINE FOR DISCUSSION:

Concepts for **POSTAL TRANSFORMATION**

September 30, 2001

JOHN E. POTTER
POSTMASTER GENERAL, CEO



October 1, 2001

Honorable Joseph I. Lieberman
Chairman
Committee on Government Affairs
United States Senate
Washington, DC 20510-6250

Dr. Mr. Chairman:

Enclosed is a document that takes the first step in developing the Comprehensive Transformation Plan for the future of the U.S. Postal Service that you requested in your letter to me of June 14.

We appreciate the opportunity that you and your colleagues have provided management and the Governors of the Postal Service to outline a Transformation Plan to address the challenges of serving the American people in the 21st century.

As you have requested, the Plan will be completed and submitted to you by year's end. As an interim step, to encourage the participation of postal stakeholders, the Postal Service is issuing this paper entitled, "*Outline for Discussion: Concepts for Postal Transformation.*"

The *Outline* reviews the need for postal transformation and describes the framework that the Postal Service is using to prepare the Plan and to compare the pros and cons of various options. The *Outline* includes a summary of challenges and the opportunities for change. We hope that this *Outline* can provide a starting point for both the experienced postal observer and the citizen who is concerned with the future of this institution to enter into a discussion about our transformation.

Please let me know if you would like to get together to discuss the *Outline* or any other postal issues.

Sincerely,

A handwritten signature in cursive script that reads "John E. Potter".

John E. Potter

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EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

The United States Postal Service is one of America's most enduring institutions, an enormous communications network designed to "bind the nation together through the personal, educational, literary, and business correspondence of its people."¹ An independent entity of the federal government, it is directed by law to provide universal postal communications to all persons residing in the United States. It was established before the American Revolution and has functioned without interruption for 226 years. Today, with annual revenues approaching \$68 billion, it is the eighth largest organization in the country, and, if included, would rank as the twenty-sixth largest enterprise on *Fortune* magazine's Global 500. It has a career workforce of nearly 800,000, which makes it one of the largest employers in the nation, and its diverse products and services anchor an \$871 billion mailing industry, which in turn employs nearly 9 million Americans.

However, today's soft economy, changing global markets, new technologies, and the need to deliver mail to an ever-increasing number of addresses are combining to put the future of the Postal Service at risk. The Congress and the General Accounting Office have taken note of this and asked the Postal Service to produce a Comprehensive Transformation Plan by the end of the year that will address how the Postal Service proposes to meet these challenges. This document, *Outline for Discussion: Concepts for Postal Transformation*, is a progress report on the Postal Service's first steps toward transformation and an open invitation to stakeholders to join the discussion. The Postal Service is reaching out to the American public and policy makers and asking them to consider how the Postal Service can best serve them and the American economy in the 21st century.

THE POSTAL ENVIRONMENT

While much of the previous decade was marked by financial success for the Postal Service, significant marketplace shifts – emerging alternative communications technologies, new competitors both domestic and international, and changing consumer attitudes and behaviors – have altered the landscape. Within the next decade technological innovations such as mobile commerce, broadband Internet access, interactive TV, data mining software, and new printing technologies will change the way businesses and consumers interact. Domestic delivery firms, such as United Parcel Service (UPS) and FedEx, and liberalized foreign posts, such as Deutsche Post World Net and TPG of the Netherlands, are

¹ Title 39, U.S. Code, Sec. 101 (a).

aggressively competing in Postal Service markets. These drivers for change are moving rapidly and will continue to change the traditional postal business whether or not the Postal Service transforms.

Meanwhile, although the six major markets in which the Postal Service operates – retail, financial services, communications, advertising, logistics and delivery services – are expected to grow, the long-term role of the Postal Service in those markets is uncertain. Electronic billing and payments, pre-authorized debits to bank accounts and credit cards, and Internet-enabled Electronic Data Interchange will reduce the need for and use of paper bills and payments. Electronic communications will grow at a much more rapid pace than traditional hard-copy communications, particularly on the Internet. Using modern technology, advertising will be more targeted, personalized, and interactive. The logistics and delivery markets will use increasingly sophisticated information systems to provide integrated, supply chain management solutions to customers' needs. Global liberalized posts are acquiring logistics companies and other mail-related businesses both in and outside of the United States to position themselves as communications and logistics global conglomerates. The United States Postal Service, operating under current law, has not joined them.

CHALLENGES

The current legal framework is but one of several challenges that has led the Postal Service and its stakeholders to seek change. Future challenges to success exist within postal operations, in the structure of postal finances, and in the necessity to find, train, and equip the workforce and its future leaders. Each of these areas requires attention in any discussion of the future. Among the specific issues to address is that possible reduced mail volume, when combined with cost increases for labor, employee health care and retirement costs, fuel, and facilities will drive a continuing gap between revenue and expense with severe financial implications for the Postal Service.

As the Postal Service nears its statutory \$15 billion debt ceiling, it faces a critical challenge in terms of cash flow and capital investments. Capital investments have reduced costs through mail processing automation, but future productivity gains may be harder to find. Technology investments, likewise, are necessary to transform service offerings and prices to meet future customer requirements. The break-even requirement of the Postal Service and the uncertainty of the future economy will also make these investment needs difficult to fulfill.

Controlling the costs associated with the universal service obligation is another challenge. A transformed Postal Service must consider alternative methods of reducing these costs and providing universal service as mail volume growth declines and the delivery network expands. Network improvements will be considered in the Transformation Plan to reduce these costs. Challenges in the human capital arena include workforce planning and complement adjustments within the constraints of current labor agreements. Today's binding arbitration processes eliminate the threat of labor stoppage, but many believe that these processes could be improved. Postal Service compensation must also be reviewed, since today's salary caps drive some potential leaders as well as skilled, experienced executives to other organizations.

Taken together, these internal and external issues form a series of challenges that the Postal Service, as currently structured and regulated, must address. If a private corporation

faced these same challenges, it might close facilities, reduce output or services, sell assets, abandon some unprofitable ventures, merge with another company, or even close its doors. These are not options for the Postal Service. It must continue to operate to fulfill its obligation to the nation. How it will do so and in what structure are the challenges of transformation.

TRANSFORMATION STRATEGIES

The *Outline for Discussion* proposes three phases of organizational transformation for consideration and, within each phase, discusses several strategies. The three parallel phases to be considered are:

- Incremental administrative and operational improvements possible under current law;
- Moderate legislative reforms; and,
- Fundamental structural transformation.

Current Postal Service actions to freeze capital expenditures, reduce the number of managerial employees, and take costs out of operations are examples of incremental administrative and operational transformation, and fall within the legal and public policy framework that exists today. Through administrative and operational action that is permitted under the current law, the Postal Service would continue to use existing authorities to reduce costs, increase efficiency and generate new revenues. The model for this phase is continuous improvement of the current Postal Service.

The objective of moderate legislative reform would be to improve the flexibility of the Postal Service and prepare it for the future. Key reforms could include more flexible pricing, allowing the Postal Service to make a profit, adoption of network improvements, and compensation changes. The options for legislative reform range from modest reforms that would enable streamlined rate-setting processes, to reforms that would grant the Postal Service greater commercial freedom. One aspect of this change might be structural separation between monopoly services and competitive services, a topic discussed for several years during debate over legislative reform.

Fundamental structural transformation would reconstruct the basic postal model based on a redefinition of a universal service obligation. This phase could entail transformation into a for-profit corporate enterprise, owned either by the government, Postal Service employees, or the public through an offering of stock. Still other fundamental structural reform models may be suggested by stakeholders in coming weeks. All would seek to achieve fundamental reform of the factors that contribute to postal costs and revenues and the basic business model of the Postal Service that has existed since 1970.

STAKEHOLDER INPUT AND NEXT STEPS

A Steering Committee of senior executives selected by the Postmaster General will formulate the Transformation Plan. The Postal Service will coordinate stakeholder input and internal analysis of the transformation phases. Subject matter experts and specialists throughout the enterprise will develop strategies and analyze the impact of proposed changes. Specialists from other government agencies and the private sector will also be asked to focus on and address Postal Service transformation issues.

To obtain stakeholder participation in the development of the Transformation Plan, the Postal Service has developed a two-step stakeholder engagement plan. Step One was designed to provide background for this *Outline for Discussion* and entailed a dozen informal meetings in August and September 2001. Postal Service executives and representatives of postal policy makers, unions, management associations, the Postal Rate Commission, major mailers, and postal trade associations participated. Outreach during Step Two will include publication of the *Outline for Discussion* on the Postal Service's Strategic Direction web site at www.usps.com/strategicdirection. In addition, a special notice will be placed in the *Federal Register*, directing interested parties to the web site for their comments. Focus groups of small business owners and consumers will be convened, and postal employees will be reached through internal communications. Additional meetings will be conducted with representatives of postal unions, management associations, the Postal Rate Commission, major mailers, suppliers, competitors, critics and others. A summary and analysis of stakeholder comments will be incorporated in the Comprehensive Transformation Plan to be submitted at year end.

This *Outline for Discussion* is a "living document," the first step in a complex, ongoing process. The collected input, analysis, and conclusions will assist policy makers as they guide the future of the United States Postal Service. The basic questions that are raised in this document are:

- To best serve the needs of the American people and the American economy in the 21st century, what should America's postal system be like (or transform to) in the next decade?
- Should that postal system provide universal service and what should that entail?
- What should the "core" services of the future postal service be?
- How should the nation structure a future postal system to be as productive and efficient as possible and to ensure that consumers pay only what they wish to pay, for as much service as they can afford?
- Can the Postal Service continue to provide universal service under the current financial arrangements if volume slows or declines significantly? Are there other financing mechanisms needed?
- What steps should be taken today to anticipate the human capital requirements of the future postal system in a manner that embodies core values of respect, dignity and diversity while providing incentives to encourage continuous service improvement?
- Is it possible to design a government postal system in the United States that operates more commercially and still serves important social objectives including universal coverage?
- How would a privately owned postal entity or entities perform against public expectations for postal services? Are there other models that may do a better job for the American people?

Informal discussions with stakeholders and policy makers have reconfirmed that there is a lack of policy consensus about the answers to these questions and others. There may not be a need for all stakeholders to agree on every question. But it is expected that there may need to be a process of public policy discussion before issues can be resolved and a widely accepted transformation plan can be crafted. The purpose of this *Outline for Discussion* is to facilitate that process.

PREFACE

PREFACE

In 1995 the Postmaster General of the United States called for legislative reform. That same year the House of Representatives Subcommittee on the Postal Service began an intensive review of the law under which the Postal Service has operated since 1971 and determined that current law would no longer suit the needs of the nation in the 21st century. In the ensuing six years, efforts in the House to modernize postal law have provided ongoing opportunities for the postal community to address, discuss, and analyze proposals about the future of the Postal Service. These efforts are continuing.

In March of 2001 the Postal Service Board of Governors wrote the President and Congress asking for a comprehensive review of postal laws.² In April of 2001, in testimony before the House Government Reform Committee, the Comptroller General of the United States placed Postal Service transformational efforts on the General Accounting Office's (GAO) high-risk watch list.³ The Committee asked the Postal Service for its recommendations, and the Postal Service Board of Governors responded, writing to the House and Senate oversight committees that "we believe that regulatory reform is needed for the preservation of universal service."⁴ The Senate also asked the Postal Service for its recommendations and, on June 14, 2001, the chairmen and ranking members of the Senate oversight committee and subcommittees⁵ wrote to the Postmaster General requesting that a Comprehensive Transformation Plan be completed by the end of the year.

The Comprehensive Transformation Plan will be submitted to Congress at the end of the year. Congress has urged the Postal Service to develop this plan in partnership with its stakeholders. *This Outline for Discussion: Concepts for Postal Transformation* is an interim report. This paper tells the Postal Service's story to explain why transformation is needed and to provide a context for discussing alternative choices for taking action. Many readers may be familiar with this detail and some may wish to turn to Section 6. The report is designed to generate discussion among all postal stakeholders to address the fundamental question: "*To best service the needs of the American people and the American economy in the 21st century, what should America's postal system be like (or transform to) in the next decade?*"

² The Board of Governors March 2, 2001 letters to the President of the United States and to Congress. (Appendix A.)

³ U.S. Postal Service: *Transformation Challenges Present Significant Risks* (GAO-01-598T) Testimony of Comptroller General David Walker before the Committee on Government Reform House of Representatives, April 4, 2001. (Appendix A.)

⁴ The Board of Governor's May 15, 2001 letter to the oversight committees. (Appendix A.)

⁵ The June 14, 2001 letter sent to Postmaster General John E. Potter from Senators Joseph I. Lieberman, Chairman, Senate Committee on Governmental Affairs; Fred Thompson, ranking member; Daniel K. Akaka, Chairman of the Subcommittee on International Security and Proliferation and Government Services, and Thad Cochran, ranking member of the Subcommittee. (Appendix A.) Mr. Potter's June 25, 2001 response is also included in Appendix A.

INTRODUCTION

SECTION 1: INTRODUCTION

THE UNITED STATES POSTAL SERVICE: WHY TRANSFORM?

The United States Postal Service is one of America's most enduring institutions, an enormous communications network designed to "bind the nation together through the personal, educational, literary, and business correspondence of its people."⁶ A self-sufficient, independent entity of the federal government, it is directed by law to provide universal postal communications to all persons residing in the United States. It was established before the American Revolution and has functioned without interruption for 226 years. Today, with annual revenues approaching \$68 billion, it is the eighth largest organization in the country. If included, it would rank as the twenty-sixth largest enterprise on *Fortune* magazine's Global 500. With nearly 800,000 career employees, the Postal Service is one of the largest employers in the United States. In addition, its diverse products and services anchor an \$871 billion mailing industry, which in turn employs nearly 9 million Americans and represents approximately 9 percent of the nation's Gross Domestic Product.⁷

Daily, more than 250,000 Postal Service letter carriers deliver to the nation's 135 million addresses, while the Postal Service's 38,000 post offices, stations and branches provide more retail outlets than McDonald's and ExxonMobil combined.⁸ In 2000 the Postal Service carried 46 percent of the world's mail, delivering more than 207 billion pieces, and added 1.7 million new delivery points nationwide, a number equivalent to a city about the size of Chicago. In roughly one week Postal Service mail volume matches the annual volume of United Parcel Service, and in two days the Postal Service delivers what FedEx delivers in a year.

Record mail volume, record service points and record revenue should assure financial stability for the Postal Service, but today's soft economy, changing global markets, new technologies, and the ever-increasing number of addresses challenge that future. The Postal Service faces aggressive competition from both domestic and foreign sources.⁹ Its letter mail services are increasingly vulnerable to substitution from new technologies, for example,

⁶ Title 39, U.S. Code, Sec. 101 (a).

⁷ Data developed for the *Mailing Industry Taskforce Report* by the United States Postal Service Market Intelligence and Segmentation Group, 2001 (Breakout of estimate found in Appendix B.)

⁸ Data taken from McDonald's 2000 *Annual Report* and ExxonMobil 2000 *Annual Report*.

⁹ There are approximately twelve postal administrations that compete directly with the Postal Service. Some of these posts, e.g., the United Kingdom's Consignia, Deutsche Post World Net, Canada Post Corporation, and TNT Post Group of the Netherlands, have a physical presence in the United States. Deutsche Post World Net's recent acquisition of DHL, the Postal Service's strategic alliance partner in the Postal Service's Global Express Guaranteed mail product, is an illustration of the competition facing the United States Postal Service.

phone-based and online bill payment.¹⁰ Competition, electronic substitution and the weak economic outlook put the Postal Service's existing revenue stream at risk. Meanwhile, investments required to expand and improve the postal delivery network are resulting in growing organizational debt, and the Postal Service could exhaust its statutory \$15 billion borrowing limit by the end of fiscal year 2003. As a result of these marketplace and business realities, the Postal Service confronts the prospect of steady and ever-widening losses.

If a private corporation faced these same challenges, it would reconsider its product offerings and adjust its infrastructure to better balance customers' needs with price elasticities. Actions such as reducing the number of retail outlets, adjusting service standards, and matching frequency of delivery to volume to be delivered would be taken. Not all of these options are available to the Postal Service. Some stakeholders believe that to maintain its financial viability the Postal Service will need to consider politically unpalatable options.

At issue is whether the Postal Service, an asset held in common for the citizens of the United States, can continue to provide the affordable, ubiquitous and secure mail service on which the nation depends. Whether for personal or commercial communications or for building community or enabling commerce, mail today remains vital to the nation's daily life and economic health. For example, more than \$1 trillion in financial transactions move through the mail every year.

Whether the Postal Service can, under the current financial and regulatory model, continue as a self-sustaining service organization is at issue. Congress, the Government Accounting Office (GAO), and the mailing community are raising critical public policy questions about how relevant the Postal Service will remain if current trends continue. With this document, the Postal Service seeks to promote a public process of deliberation. This process will enable Americans to focus on the critical issues confronting the Postal Service, gain the insights of experts and of diverse interested parties, contribute to a national discussion of the issues, and ultimately through the actions of its representatives decide the future of the Postal Service.

TRANSFORMATION APPROACH AND KEY ISSUES

At year-end, the Postal Service will deliver a Transformation Plan to Congress and to the President. To develop this plan, the Postal Service will consider the following key issues 1) the current and future mission of the Postal Service; 2) legislative and administrative reforms necessary to address the underlying structural barriers that affect the ability of the Postal Service to fulfill its mission; and, 3) the human capital, operational and financial implications of these reforms. What is clear is that inaction on these issues is not an option. As the Comptroller General testified:

The Service is at growing risk of not being able to continue providing universal postal service vital to the national economy, while maintaining reasonable rates and remaining self-supporting through postal revenues.¹¹

¹⁰ Approximately one-quarter of Postal Service revenue comes from the delivery of bills, statements, and payments.

¹¹ U.S. Postal Service: *Transformation Challenges Present Significant Risks*, Statement by David M. Walker, Comptroller General of the United States, testimony before the Committee on Government Reform, House of Representatives, April 4, 2001, p 18. (Appendix A.)

This *Outline for Discussion* describes three transformational phases. The three phases suggest a path toward a more commercial, competitive Postal Service. They are 1) incremental but aggressive administrative and operational improvements without legislative change; 2) moderate legislative reform providing some additional flexibility; and, 3) fundamental structural transformation. Within the three phases are a range of options: from focusing on investments in revenue growth and increased efficiency under the current model, to a “corporatized” enterprise within a competitive market.¹² The three phases will be analyzed as parallel phases, allowing the Postal Service to highlight the actions that should be taken today to prepare for the Postal Service of the future.

During October 2001, the Postal Service will further engage the public through additional meetings with postal policy makers, mailers, representatives of labor and employee groups, the Postal Rate Commission, small businessmen and citizens, asking them for feedback. Opportunities for formal public review will be provided, and comments on the impact and importance of the three phases will be solicited.

QUESTIONS FOR PUBLIC COMMENT

In considering these major challenges and the financial, operational and human capital implications of each, a key question is how the Postal Service should transform to prepare for the business environment it will face in the future. This question will be considered as the Transformation Plan is developed and product improvements, network optimization, workforce planning, financial and administrative restructuring and other strategies for each phase are examined.

The *Outline for Discussion*, background material and a series of related questions may be found on the Postal Service’s Strategic Direction web site at www.usps.com/strategicdirection or at www.usps.com keyword: transformation. Printed copies can be obtained by calling 202-268-6005. Comments should be emailed to: transformation@email.usps.gov, or mailed to Julie S. Moore, Executive Director, Office of Transformation, Strategic Planning, Room 4011, U.S. Postal Service Headquarters, 475 L’Enfant Plaza, SW, Washington, DC 20260-1520. Comments must be received by November 1, 2001.

¹² In order to generate discussion around future visions, five scenarios within the three transformational phases were shared in preliminary, informal meetings with representatives of 12 groups identified in Section 7: Stakeholder Input. Appendix C includes an overview of these five scenarios.

THE CURRENT STATE OF THE UNITED STATES POSTAL SERVICE

SECTION 2: THE CURRENT STATE OF THE UNITED STATES POSTAL SERVICE

THE HISTORY AND STRUCTURE OF THE UNITED STATES POSTAL SERVICE

When the Continental Congress named Benjamin Franklin the first Postmaster General in 1775, the United States was a weak confederation of colonies scattered along the eastern seaboard. The postal system created by the Congress helped bind the new and expanding nation together, supported the growth of commerce, and ensured a free flow of ideas and information.

For nearly 200 years the federal government ran the postal system under close political supervision. Postmasters General, dating back to Andrew Jackson's administration in 1829, were members of the Cabinet. As the nation expanded westward, the Post Office Department expanded as well. Operating on the forefront of technological innovation, the Post Office Department was first in the commercial use of railroads, automobiles, and airplanes in its quest to expedite the delivery of correspondence across a growing nation and to create the necessary vast communications infrastructure to support that delivery.

By the mid-1960s, however, the Post Office Department was in trouble. Years of financial neglect and fragmented control had impaired its ability to provide modern facilities, equipment, wages, and management efficiency. In addition, heavily subsidized postage rates for all classes of mail bore little relation to costs.

After service failures in Chicago in 1966, and ensuing labor unrest, Congress approved and President Richard M. Nixon signed into law the Postal Reorganization Act of 1970. The new law restructured the postal system into an "independent establishment of the executive branch."¹³ To run the postal system the legislation created an 11-member Board of Governors, including 9 Presidential appointees plus the Postmaster General and Deputy Postmaster General. The new United States Postal Service was intended to insulate postal operations from politics, ensure greater management authority for the Postmaster General, and create a collective bargaining structure with binding arbitration to banish potentially crippling strikes. In addition, the new Postal Service, which began operations in 1971, was to be self-supporting with a break-even financial mandate.

The 1970 law preserved the historic public mission of the Postal Service to maintain universal service for every United States address. To help protect the financial base necessary to perform this mission, the law also preserved traditional monopoly protections for letter mail and reserved access to the mailbox. As a government organization with a statutory monopoly, the Postal Service is highly regulated. The 1970 legislation created an

¹³ Title 39, U.S. Code, Sec. 201.

independent Postal Rate Commission, which holds lengthy and public administrative hearings before rates and mail classifications can be changed. The Postal Service is also subject to extensive government review through several congressional oversight bodies, the General Accounting Office and, since 1996, the Office of the Inspector General, which is independent of postal management.

THE MISSION OF THE UNITED STATES POSTAL SERVICE

When the Postal Reorganization Act became law in 1970, two sections, one on postal policy and the other on general duties, spoke most directly to the “mission” of the newly created United States Postal Service. The overall mission established by the law was:

to provide postal services to bind the Nation together through the personal, educational, literary, and business correspondence of the people, and to provide prompt, reliable, and efficient services to patrons in all areas¹⁴

Among the general duties of the new entity were to:

provide adequate and efficient postal services at fair and reasonable rates and fees, and ...receive, transmit, and deliver throughout the United States, its territories and possessions, and, throughout the world, written and printed matter, parcels, and like materials and provide such other services incidental thereto as it finds appropriate to its functions and in the public interest.¹⁵

These policy and operational directives codified the historical mission of the American post. Many stakeholders have expressed their views that the universal service mission of the Postal Service might need to be further defined to meet the future market environment.

THE UNIVERSAL SERVICE MISSION

The Postal Service mission forms the basis of what is sometimes thought of as the Postal Service’s universal service obligation, popularly described as mail service to “Everyone, Everywhere, Every Day.” The universal service mission, in turn, with other social obligations, has been part of the justification for the Postal Service monopoly, codified as the Private Express Statutes and other authorities related to delivery. The Private Express Statutes grant the Postal Service the exclusive right, with certain limited exceptions, to carry letters for compensation.¹⁶ Another statute prohibits any person from placing material into a mailbox.¹⁷ These statutes were adopted to ensure the Postal Service a revenue base sufficient to provide universal service. In other words, the Private Express Statutes seek to assure enough revenue so that the Postal Service can serve all communities, large and small, even in places where the service does not pay for itself.

Universal service today encompasses a wide array of products, a uniform price for letters sealed against inspection, six-day-a-week, nationwide delivery, and nationwide access to an extensive postal retail network. Universal service also includes affordable, fair and equitable prices for all citizens and all mailers. According to some economists, any universal

In the future, how shall universal service be defined?

¹⁴ Title 39, U.S. Code, Sec. 101 (a).

¹⁵ Title 39, U.S. Code, Sec. 403 (a).

¹⁶ Title 18, U.S. Code, Sec. 1693-1699; Title 39, U.S. Code, Sec 601-606.

¹⁷ Title 18, U.S. Code, Sec. 1725.

service obligation, regardless of industry, must address 1) the scope and manner of service (frequency and speed of delivery); 2) access; 3) affordability; 4) array of products; and, 5) the security of the transmission.¹⁸ In recent years various postal experts have suggested that the above five universal service elements could be met with non-traditional means and that the Postal Service could still fulfill its mission requirement to "bind the nation together." A number of stakeholders have agreed and recommended that postal universal service be specifically defined and its cost analyzed and distinguished from commercially viable services. However, in foreign posts and in other industry sectors such as telecom, aviation, and utilities, determining the cost of universal service as a distinctive component from profitable operations has proven difficult and highly contentious.

THE MONOPOLY AND REGULATION

Public policy today generally demands that grants of monopolies, necessary in certain instances to ensure a universal service mission, be accompanied by some form of regulation to protect the public interest. Regulation varies markedly by country and industry, and its object is to assure that the protected enterprise performs reasonably, fairly, and at affordable costs. In the current postal structure, the Governors and the independent Postal Rate Commission, a total of 14 Presidential appointees, have the primary responsibility for determining postal rates, classifications, and new services. In a major rate case, the Governors request some 4,000 rates that it has determined meet 9 statutory rate-setting criteria, including a fair and equitable rate schedule, the value of mail to sender and recipient, and the educational, cultural, scientific, and informational value of the mail to recipients.¹⁹ As long as a universal service mission and some form of monopoly protection apply, most stakeholders believe that Congress is likely to impose some form of regulation. What regulatory improvements might be more suitable for the future will need to be addressed, along with stakeholder suggestions and policy maker involvement in defining the issues of mission and universal service.

The underlying drivers for universal service are market demand and consumer and industry expectations. These expectations may change as behaviors, technologies, and competitive responses evolve.

THE CURRENT POSTAL SERVICE MARKET

THE DOMESTIC PICTURE

Since the 1970 Postal Reorganization Act, mail volume in the United States has increased nearly 80 percent per capita,²⁰ and overall has grown 139 percent. Delivery points have increased by 69 percent, while efficiencies have kept the growth in postal employment to only 24 percent. Many new products, alternatives, and discounts have been offered to postal customers. Among government agencies, the Postal Service has been recognized as a leader in many areas of technology and financial planning.²¹ While remaining a government organization, the Postal Service has, until recently, been one of the world's

¹⁸ Security of the United States mail is the purview of the Postal Inspection Service, a Federal law enforcement agency with jurisdiction in criminal matters affecting the mail. It provides assurance to American businesses for the safe exchange of funds and securities through the U.S. Mail; to postal customers of the "sanctity of the seal" in transmitting correspondence and messages; and to postal employees of a safe work environment.

¹⁹ Title 39, U.S. Code, Sec. 3622.

²⁰ *Postal Technology International*, June 2001, p.20.

²¹ *Governmental Executive*, April 2001 Special Issue: Grading Government, pp 55-64

more liberalized and forward-looking posts. What was not foreseen in 1970 was today's ongoing technological revolution, with an impact on hard-copy delivery that remains to be fully assessed and understood.

THE MAILING INDUSTRY

The Postal Service, as noted, is a major presence in the market. The Postal Service purchases or leases billions of dollars worth of facilities, vehicles, equipment, and supplies every year. Postal employees purchase uniforms, services and other items associated with their work. Much of the revenue earned by the Postal Service returns to the economy quickly and directly. The rest returns indirectly through the salaries and benefits of postal employees, who represent significant consumer buying power in their communities.

The Postal Service and its competitors represent only \$206 billion of the \$871 billion mailing industry. Many of the companies in the mailing industry were created in response to postal policies of outsourcing and providing "worksharing" discounts to mailers for performing work that the Postal Service would otherwise do. Today the mailing industry is diverse, ranging from giant printing establishments to graphic arts enterprises. Many of the players are direct intermediaries between the Postal Service and the owners of the mail, while others are services, often separate subsidiaries or contract services, that run large mail production plants or payment processing centers. This industry, representing businesses that provide direct and indirect mailing services – the technology, the infrastructure, the access and the preparation of mail pieces themselves for the network – generates approximately \$430 billion in revenues in the United States and employs about 6.3 million people.²²

MAIL INTENSIVE INDUSTRIES

While virtually every establishment in the United States sends or receives mail, most mail volume is generated directly or through mailing industry intermediaries. For these industries, mail is an integral part of their business processes. These segments include mail order companies, for which the Postal Service delivers the majority of packages between businesses and consumers. Mail order companies use a variety of delivery services and communication media, but they still rely on the mail, especially for delivery of their catalogs.²³ The domestic mail order industry generates approximately \$111 billion in sales and employs about 300,000 people.²⁴

Other major players are the publishing and printing industries. One of the specific purposes of the postal system is to ensure national reach for magazines, newsletters, and newspapers. This function has been deemed essential enough by Congress to warrant continued special attention and treatment in the mail system through reduced rates on editorial content. Although most newspapers are delivered locally through non-postal networks, many publishers still depend on the postal system to deliver non-local copies to subscribers who keep in touch with their former home communities. Publishers of smaller non-daily newspapers are more dependent upon the mail system, despite the availability of electronic distribution and non-postal delivery alternatives.

²² Data developed for the *Mailing Industry Taskforce Report* by the United States Postal Service Market Intelligence and Segmentation Group, 2001. (Breakout of estimate found in Appendix B.)

²³ *Forecasting the Consumer Direct Channel: Business Models for Success*, Peppers and Rogers Group and the Institute for the Future, 2000.

²⁴ Data developed for the *Mailing Industry Taskforce Report* by the United States Postal Service Market Intelligence and Segmentation Group, 2001 (Breakout of estimate found in Appendix B.)

Publishing generates approximately \$100 billion in domestic sales and employs about 900,000 people. Adding in printers associated with greeting cards, documents, forms, labels, and other items that eventually go into the mail, the total rises to about \$124 billion in revenue.²⁵

The direct mail production process, including creative services, graphic arts, list management, fulfillment and other services, also contributes to the economy at the retail level in terms of revenues and employment.

THE LARGER MARKET

The Postal Service and the mailing industry exist within a larger market for communications services. These include other advertising services (non-direct marketing), telephone and electronic messaging services, and associated industries. The communications firms, in addition to being large customers of the Postal Service and the mailing industry, are also indirect competitors. Changes in the structure of the Postal Service, the mailing industry, and postal markets will also affect these firms. These firms account for about \$725 billion in sales and employ about 2.2 million workers.²⁶

THE GLOBAL PICTURE: THE INTERNATIONAL MAIL MARKET TODAY

The international mail market today includes global delivery services for letters, printed matter such as advertising mail and catalogues, standard packages, and expedited shipments that weigh less than 70 pounds. The market revenue for export delivery services from the United States is \$6.25 billion, with the standard parcels expedited shipment segments comprising more than 80 percent of this global opportunity. The market revenue for import delivery services to the United States is approximately \$4 billion.

The United States Postal Service currently has a dominant position in the traditional letters and printed matter segments that comprise the remaining 20 percent of the market. However, these segments are stagnant, with little growth forecasted for the future as technology offers customers faster, electronic solutions to deliver their messages in a global market place. Additional competition in these segments comes from foreign postal administrations, which have established a sales presence in the United States since 1986, when monopoly protection for outbound international mail was eliminated.

The market segments for standard parcels and expedited shipments have grown dramatically in the past 15 years, although this annual growth has slowed to less than 10 percent in recent years. Annual growth on a global scale is forecasted at 5 percent for the next several years, with some geographic regions, such as Asia-Pacific, forecasted for faster growth. Global integrators such as FedEx, UPS, and DHL are the dominant service providers in these segments, comprising about 93 percent of the American market.

In recent years a number of industrialized countries have commercialized their Posts, among them Deutsche Post, TPG of the Netherlands, Consignia of Great Britain, La Poste of France, New Zealand and Australia Post. Ad J. Scheepbouwer, CEO of the Netherlands' post, TPG, predicted that "In the future there will be just four Super Posts, and the sleeping giant of the United States Postal Service will not be one of them."²⁷ Despite Scheepbouwer's comments, the American people still have a say in how this prediction turns out.

²⁵ Ibid.

²⁶ Ibid.

²⁷ *Global Competitive Update: "Playing the Hand Dealt in a High Stakes Environment,"* PricewaterhouseCoopers. January 2001: p 6. Document written for the United States Postal Service.

DRIVERS FOR CHANGE

SECTION 3: DRIVERS FOR CHANGE

The current market environment offers many challenges for the Postal Service and the mailing industry as a whole. While addressing these challenges, the industry must not lose sight of the need to fit into a future environment that is being shaped by consumer behavior, technological changes and the increasing sophistication of both domestic and global competitors. The world is changing and will continue to change, whether or not the United States Postal Service changes with it.

What should the “core” services of the future Postal Service be?

CONSUMER BEHAVIOR

Changes to the postal markets will influence a large portion of the American economy. Directly or indirectly, the postal sector accounts for more than \$871 billion in sales and employs more than 9 million people in the United States. Trillions of dollars in payments are made through the mail annually. The Postal Service and its physical delivery competitors deliver billions of packages annually to businesses and households. The growth of consumer retail spending currently depends, in part, on the ability of the mail system to influence demand.

Within a decade about 60 percent of American households will be considered “new consumers,”²⁸ highly educated and affluent by historic standards. These consumers, representing all ages, genders, and ethnic groups, will be extremely information intensive and will use all media, with the possible exception of television, more intensively. They will exercise more control over the media and messaging presented to them and will expect more flexibility and responsiveness from the channels and from content providers. The new consumers will be highly mobile and will pay attention only to relevant, carefully targeted messages or those from trusted and pre-approved sources. They will demand appropriate prices, quality, convenience, ease of use, and sufficient levels of choices or features.²⁹

At the same time, businesses will continue to depend on physical documents for communicating with customers, and publishers and printers will rely on a national marketplace for publications and printed material.

²⁸ 2010 Customers, Markets, and Opportunities Assessment, PricewaterhouseCoopers, 2001, p 7.

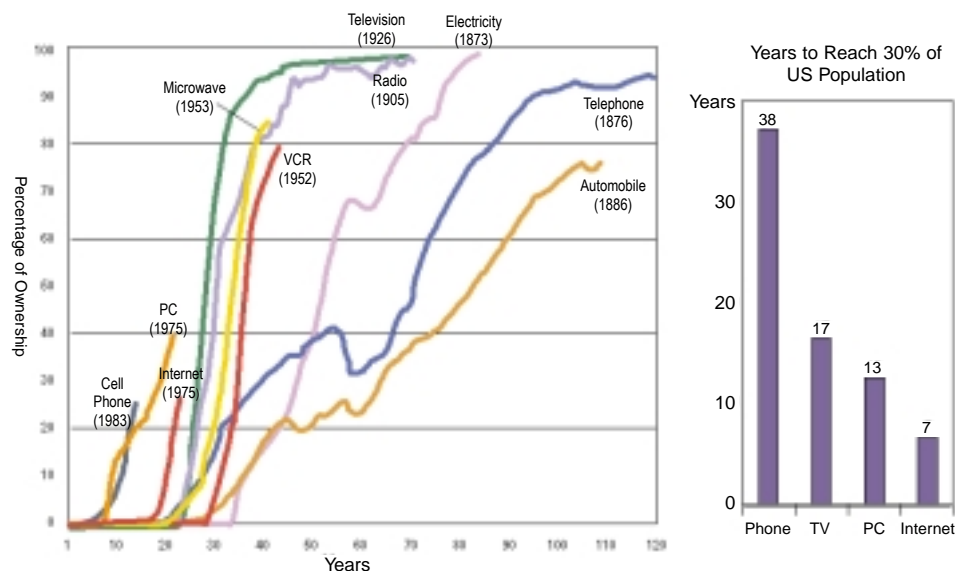
²⁹ 2010 Customers, Markets, and Opportunities Assessment, PricewaterhouseCoopers, 2001, pp 7-9.

TECHNOLOGY

Within the next decade further technological innovations such as mobile commerce, broadband, interactive TV, data mining software, and new printing technologies will change the way businesses and consumers interact. The Internet and the World Wide Web have been and will continue to be drivers of technological change, with a majority of U.S. households having improved Internet access within the next few years. Traditional communications media, including postal services, have invested a great deal of energy and money in attempting to harness the Internet to improve speed, reduce costs, and increase the convenience of interaction with customers.

Parallel improvements in database management and computation have driven changes in data aggregation and analysis. Together, these drivers provide the platform for more changes in the future, especially as mobile communications technology becomes integrated with existing channels, and as security and access speeds continue to improve. What is particularly noteworthy about future technological change is the pace at which such change is occurring. It took 38 years for the telephone to reach 30 percent of the population; it took 17 years for television to reach the same number of people, and only 13 years for personal computers to establish the same market penetration. The Internet reached 30 percent of the population in just seven years. The following chart illustrates the pace of technology innovation and adoption of the automobile, telephone, electricity, radio, television, VCRs, microwave, PCs, Internet and cell phones.³⁰

TECHNOLOGY ADOPTION



Much of the discussion on the impact of technology on the mail and the Postal Service has been negative – that electronic communications will ultimately displace mail volume. There is no doubt that some traditional mail applications will be diverted. It is, however, possible that the new technology could create opportunities that might be compatible or complementary with traditional mail. Improvements in database

³⁰ United States Postal Service, *The Household Diary Study, Mail Use and Attitudes in Postal Fiscal Year 2000*.

management and printing technologies may also lead to improvements in the effectiveness and value of mail through greater customization and more rapid response. Both risks and opportunities need to be addressed when examining postal transformation.

DOMESTIC COMPETITION

The Postal Service today faces intense direct competition in many of its markets, particularly from firms such as UPS and FedEx. Such firms focus on the most profitable portions of the postal value chain, such as high-value documents and packages, delivered to businesses and high-density and high-volume neighborhoods. In some cases, these firms reduce service or increase rates for services to high cost deliveries. These firms are continuing to expand into other businesses, including an increasing portion of the postal value chain. Under the current regulatory structure, competitors have far more flexibility to respond to changes in market conditions and to target specific customers than does the Postal Service.

Smaller, alternative delivery competitors, such as WebVan, NetGrocer, and Kozmo, were not able to develop successful competitive delivery models, but there are other potential competitors that could enter the market. For example, the infrastructure of an alternative delivery system could be built on the foundations of existing retail newspaper and magazine distribution systems. There is a fragmented network already available, and consolidation could provide the necessary economies of scale and scope.

A third, more controversial and speculative form of potential future competition has also appeared in the mail value chain. Firms that are clearly competitors in other contexts have now made investments to enter into the "worksharing" portions of the value chain where the Postal Service has collaborated with mail industry suppliers and service providers. At this point it is difficult to know whether this evolving segment of the value chain is a source of future competition to the basic Postal Service business model or whether it will continue to be a unique public-private partnership that has been central to growing the mailing industry.

GLOBAL TRADE AND COMPETITION

The global competitive landscape for Posts is changing irreversibly. The expansion of the European Union (EU) is providing the economies of scale for former national postal services to emerge as global enterprises offering a wide variety of services. Liberalization of Posts in Canada, Asia and Latin America expands the competition. Foreign postal administrations such as Deutsche Post are moving far beyond traditional postal services, entering both the logistics and financial services markets while taking advantage of electronic services. They have entered the United States domestic market and intend to compete directly with the Postal Service for profitable segments of postal business. Although the EU Directive aimed at opening Europe's postal markets to competition is mired in controversy, there is continuing pressure for open markets through the EU by 2009.

This international competitive world is and will continue to be characterized by massive regulatory reforms, cross-border acquisitions, alliances, and highly targeted products and services. Although it delivers 46 percent of the world's mail, the United States Postal Service does not have the option under present law to aggressively establish a competitive presence in the global market. The Postal Service does have, however, unique value as a provider of secure mail services.

THE FUTURE POSTAL WORLD

SECTION 4: THE FUTURE POSTAL WORLD

THE MAILING INDUSTRY

The pace of the changes described in the previous section will continue to vary across applications and customer segments. The Postal Service's six major market segments – retail, financial transactions, communications, advertising, logistics, and delivery services – are all undergoing rapid change. This section offers several perspectives on potential market change and invites comments from stakeholders to guide understanding of the future marketplace.

BILLING AND PAYMENT SERVICES (FINANCIAL TRANSACTIONS)

The market for financial services will grow significantly during the next decade. Although checks will most likely continue to be a major payment mechanism well into the future, and although the nation will continue to require prompt and efficient hard copy billing and remittance processing systems based on checks, it is expected that the use of checks will continuously decline as a percentage share of the total billing and payments process. This change will be driven in large part by the substitution of various kinds of cards and other payment devices for cash and checks. Handheld personal devices will be connected to the Internet and routinely used for payment. The decline of check usage at retail outlets will reduce the volume-based productivity of traditional private sector check processors. This, in turn, will increase the pressure on businesses to eliminate check usage to avoid the increasing costs of handling paper checks. The Federal Reserve has already reported a decline in the use of checks, and federal government policy is to replace payment by check with electronic payments wherever possible for all government transactions.³¹ As with other future trends, the interaction of customer demand and suppliers of services will determine the speed and accuracy of these projections.

Account consolidation, especially due to the use of credit cards to pay multiple bills (earning airline miles or other discounts) will also affect traditional mailed-check volumes. Consolidation of accounts, and the associated consolidation of statements, will accelerate due to mergers of financial institutions.³² The Postal Service will be increasingly dependent upon a relatively few, large, financial service firms and their information system intermediaries. Many bills and statements will be transmitted electronically to a print site close to the final delivery location, bypassing much of the current processing and

³¹ Phillips Business Information, *Item Processing Report*, May 20, 2001.

³² 2010 *Financial Market Assessment*, PricewaterhouseCoopers, 2001, pp 22, 23.

transportation system, but requiring close cooperation among the mailer, printer, and the Postal Service, especially in tracking the documents.

Finally, many financial institutions, manufacturers, retailers, government organizations and information service providers are attempting to replace mailed bills and statements altogether. Electronic Data Interchange (EDI) is a long-established business-to-business practice that is moving to the World Wide Web, and in the next decade many of the current barriers to ease-of-use and security will have been resolved, at least for business-to-business bills. Many enterprises are attempting to build consumer demand for electronic bill presentment as well. Chief among them is the banking industry, which sees its current online banking customers as a captive audience for new bill presentment and payment features.

According to the *Technographics Report* from Forrester, a technology research firm, the percentage of U.S. consumers who pay bills online has been increasing dramatically since the beginning of 1999. At the beginning of 2001, the adoption rate was between 2 percent and 7 percent. By the beginning of 2002 consumer online bill payment is expected to reach 12 percent.³³ There is growing acknowledgement within the industry that an increasing number of households will inevitably accept electronic rather than mailed bills.

COMMUNICATIONS

The broadly defined communication market is expected to double during the next decade. Electronic communication will continue to grow at a much more rapid pace than traditional hard copy communications, as improvements are made in security and ease-of-use. However, mailed document volume will also likely continue to grow, based in part on the increasing ability of firms to develop customized, high quality documents and to have them delivered quickly with tracking and security throughout the production and delivery process.³⁴ The increased ease-of-use of desktop document production systems and the improvements in printer capability will also mean that additional volume will be generated, although some volume will go through the same distributed printing system used for the local production and delivery of statements.³⁵

ADVERTISING

It is anticipated that the advertising market will grow significantly during the next decade, with a diminishing difference between advertising and other communications. Both will be carefully targeted and personalized. The same desktop document production, printing, and distributed delivery system that supports advances in financial statements and business communications will enable more flexible, relevant, and timely advertising messages to be delivered to individuals within households.³⁶ Many direct mail campaigns will be integrated with other media, and technology will create new applications for interactivity between mailed pieces and other communication channels.³⁷

³³ Kenneth Clemmer, *Bill Payment Goes Mainstream*, The Technographics Report, July 2001, p 4.

³⁴ *Intelligent Document Task Force Report*, 2001.

³⁵ *2010 Communications Market Assessment*, PricewaterhouseCoopers, 2001, p 27.

³⁶ *2010 Advertising Market Assessment*, PricewaterhouseCoopers, 2001, p 25.

³⁷ *2010 Advertising Market Assessment*, PricewaterhouseCoopers, 2001, pp 18-19.

LOGISTICS

The delivery and logistics market will continue to change dramatically during the next decade, since many of the technological opportunities created by the Internet have already been incorporated into current trends. UPS, FedEx, and others have been setting the standards for the evolution of the package delivery and freight markets. Customers in the future will expect easily accessible information at all stages of the supply chain process, increasing simplification of traditional processes, and integrated solutions to customer problems, including fulfillment, financing, warehousing, and logistics services.

Most observers would probably agree that the Internet and the World Wide Web, combined with the increasing power and reduced prices of personal computers, have changed the way businesses and consumers behaved during the last decade. Yet at the beginning of the decade, few foresaw these changes. The shape and pace of change during the next decade remains equally unpredictable. Some analysts argue that the Internet is just another communication channel to which both other channels and customers will adjust. Others strongly suggest that the changes in business and customer behavior are more likely to be revolutionary, perhaps in ways that cannot now be predicted. Some argue that the electronic messaging that now accompanies parcel shipping has created new value that is as important as the package itself.

New transparency in the supply chain encourages the use of information technology to create new performance measurements and customer interconnection with suppliers. Optimization of networks and dynamic pricing are two examples of new ways of thinking about reconstituting delivery networks so that they are used more efficiently. Flexible delivery, payment services, and merchandise return services will be the distinguishing characteristics of successful firms in this market.

The unpredictability of the changing market, with the associated requirement for greater flexibility and improved responsiveness to customer needs, is at the heart of the postal transformation issue. The Postal Service must be able to continue to fulfill its mission of providing prompt, reliable universal service at reasonable rates in dynamic, competitive markets.

THE GLOBAL MARKET

DEMANDS OF THE GLOBAL MARKET

The rapid changes occurring in the domestic mail markets parallel equally rapid changes occurring in global mail markets. These changes, like domestic changes, are being driven by customers' needs. On a global scale customers are seeking to 1) drive costs out of the supply chain; 2) pay reasonable costs for universal delivery service; 3) receive the lowest possible prices, with assured service performance; 4) substitute electronic services for letter and printed matter business; 5) use hybrid letter mail; 6) use low cost re-mail offerings for international mail; 7) maximize electronic commerce; 8) use liberalized posts to provide logistics service; 9) share risk and rewards with logistics suppliers; and, 10) operate around the world.

Another set of forces also drives the global repositioning of postal and non-postal competitors. The differences between Posts and other carriers is declining as each expands its range of services to offer customers a full range of integrated, one-stop services, value added components, and the information infrastructure to control these offerings in complicated shipment scenarios. As Posts "go global," they are acquiring a full range of

logistics capabilities through acquisition. They are becoming global mail conglomerates and are entering into direct competition with other Posts and private service providers. Revenue and earnings are increasingly dependent on the ability of Posts to meet customers' global needs.

These factors are also driving Posts to redefine their role. In order for Posts to survive without being subsidized and still earn a reasonable return on investment, they must convert their services to meet the needs of customers for global "mail" service. This, in turn, creates a need for access to capital and the freedom to invest or own other critical assets.

THE FUTURE OF THE GLOBAL MARKET

Globalization of the world's economies will result in the future international mail market being driven by customers' needs for global distribution of their letters, printed matter, and packages. Households will continue to send mail around the world and will look for the most cost-effective way to do it. Business customers will send mail globally and will seek to drive costs out of their supply chains. "Mail" will consist of much more than today's letters, printed matter and parcels.

These consumer demands will drive many postal and private service providers to become global logistics providers. International logistics revenues are currently at about \$150 billion, with about half of the market derived from mail moving to or from the United States. That market is expected to grow at an annual rate of about 7 percent for the next 10 years. Postal operators and private service providers are expected to compete fiercely for shares of this market.

The future market will consist of business customers seeking a full range of integrated logistics services from their "core carriers." Performance-based contracts will be used to drive service quality, reduce costs and increase overall control of the logistics process. Customers will seek to make partners of their logistics providers, thus sharing in both risks and rewards. It is expected that successful postal operators will be fully integrated with their customers' global business processes.

There is also expected to be considerable consolidation in the industry, with a small number of reliable and highly skilled service providers able to meet all of customers' needs. The surviving large-scale, full-service logistics organizations will dominate the global mail/logistics business. Deutsche Post World Net, which includes DHL and other logistics acquisitions, is moving quickly in that direction. Other global integrators, such as FedEx and UPS, are also acquiring logistics partners to capture a future share of the global logistics market. Because the opportunity is so large, other service providers will likely emerge to compete, perhaps on a regional level, to provide logistical services on less than a global basis.

In sum, the future markets of the global mail and logistics industry will require policy makers to focus on a number of transformational issues. Key concerns that will need to be addressed include:

- Will the few players left in the market provide a competitive private marketplace in the United States?
- What will be the American public and private presence in this future global mail market?

- What effect will the presence of foreign governments and private companies being created from former national postal services have on competition and universal service in the United States?
- What impact will the new global “mail” market have on the more than 9 million American jobs associated with mail?
- How should the United States Postal Service be best positioned to contribute to the success of the American role in the new global “mail” marketplace?

CHALLENGES

SECTION 5: CHALLENGES

The Postal Service's future mail volume growth is made uncertain by new competitors (both domestic and foreign), electronic diversion, new technological communication channels, and competitive products and services from other businesses. Today's mail volume is impacted in the short run by the current economic downturn. Beyond this near-term challenge, combined with continuing cost increases for labor, employee health care and retirement costs, transportation, and facilities, inadequate volume could continue to produce a gap between revenue and expense, with severe financial implications for the Postal Service.

What structure encourages an efficient, affordable, and productive Postal Service?

These issues will be addressed in the final Transformation Plan, where in-depth analysis of the financial and operational structures, human capital, and other challenges posed by the transformation options will be presented. The purpose of this section, Challenges, is to identify major considerations and issues that will contribute to the discussion and analysis that needs to take place before the end of year submission.

OPERATIONAL CHALLENGES

Transformation will require significant operational changes due to the fundamental role the operational infrastructure plays in serving the Postal Service's customers and the American people.

The Postal Service is a massive organization. Each day, nearly 800,000 career and 100,000 temporary, casual, and other employees accept, sort, transport, and deliver more than 680 million pieces of mail to more than 135 million addresses. In roughly one week the Postal Service matches the annual volumes of United Parcel Service and in two days it delivers what FedEx delivers in a year. The Postal Service infrastructure includes 458 mail processing facilities and 38,000 post offices, stations, and branches. With its 205,000 vehicles, it operates the largest fleet in the nation, traveling more than one billion miles a year. It also purchases nearly \$5 billion annually in transportation services and is a major client of every domestic airline.

POSTAL SERVICE OPERATIONS

The average American accesses the operational infrastructure of the Postal Service when receiving mail, when dropping mail in collection boxes, and when visiting retail locations to purchase stamps or mail packages. The movement of that letter or package

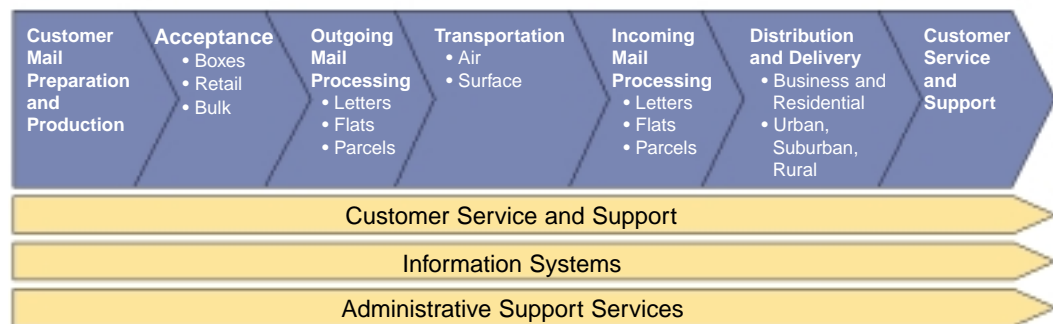
from the mailbox or retail outlet to the addressee is accomplished through a complex, multi-network structure.

The Postal Service's networks of retail post offices, distribution/sorting plants, delivery offices (often housed in retail units), and air and surface transportation connections form the physical link between the Postal Service and the 135 million American addresses. This set of networks operates whether there are 10 pieces of mail per address every day or one piece of mail per address every day. Obviously, the more volume in the system, the lower the unit costs. Resizing the network to accommodate growth (delivery points or mail volume) or decline is not a short-term proposition. This is especially true when the extent of resizing is constrained by the universal service obligation (discussed further in Section 2). In fact, there is probably a "floor" to the amount of resizing possible in an environment characterized by declining volume, increasing delivery points, and a universal service mission.

Manufacturing organizations react to declines in business by cutting back on production and shedding workers and other expenses. Service providers with significant fixed costs are less flexible, and the Postal Service, due to its universal service obligation to the customer, is significantly more constrained than most other service providers. For example, a letter carrier must deliver the route daily regardless of traffic on that route. Airlines, however, can decide, as they have in the past, to reduce network costs by eliminating points they serve or reducing the frequency with which they serve them. The Postal Service is not free to reduce its daily "flights." It is prohibited, or severely constrained, in its ability to drop delivery points from its network, eliminate retail points from its network, reduce the frequency of delivery, or change time-in-transit standards.

The following chart illustrates the main processing steps the Postal Service employs to transport the mail from the customer to a final delivery point.

POSTAL SERVICE OPERATIONS



FOCUS OF IMPROVEMENT EFFORTS

Mail volume workload and delivery points have increased significantly during the last 30 years. The workload growth has required considerable infrastructure expansion to support universal service. While mail volume growth and periodic price increases have contributed to the organization's ability to pay for that expansion, the Postal Service has also been successful at restraining costs by limiting work force growth. Despite mail volume increases of 139 percent and delivery point increases of 69 percent since 1970, postal employment has grown by only 24 percent. The result has been rate increases generally at or below the rate of inflation during the course of the Postal Service's existence.

The Postal Service has had a successful history of cost containment. Worksharing discounts, capital investments, network consolidation, productivity and growth management strategies have enabled the Postal Service to continue meeting its universal service mission with rate changes generally in line with the rate of inflation even though work load (volume and deliveries) growth during the same period has been substantial. A continuation of that success will be more difficult to achieve in the future, particularly if volumes decline as a result of electronic diversion and other market forces.

Regardless of which direction a changing environment takes, the main focus of operations strategies will continue to be providing mailers and recipients with excellent service at the lowest possible cost. Cost containment and productivity improvements are, therefore, the central themes of operations' strategies for any and all projected future outcomes. Key operational challenges of the Postal Service include variable and fixed cost containment, network optimization, service standards revisions, and mail processing automation.

Because of the relationship of operational fixed costs versus volume variable costs, the challenge becomes significantly more difficult to meet in times of declining volumes. Mail volume variability that results in economies of scale in a volume growth environment limits the Postal Service's ability to reduce costs in a declining volume environment.

VARIABLE COSTS

Historically, the Postal Service has offset substantial increases in labor costs, due both to wage rate increases and workload growth, through workshare discounts and automation. Although there are some opportunities for improvements, the majority of workshare and automation efficiencies in the current system have been realized. There are few opportunities for additional workshare discounts with significant effect on total operating cost.

Letter automation also has been effective in removing costs from the system. Remaining automation and mechanization opportunities for flats and material handling will have less overall impact. Because of lower projected absolute savings and the statutory borrowing ceiling, capital funds for investment and mechanization are limited. Since there is no indication that wage rates will rise more slowly in the future, total labor costs will grow despite continued efforts directed toward workshare and automation strategies.

FIXED COSTS

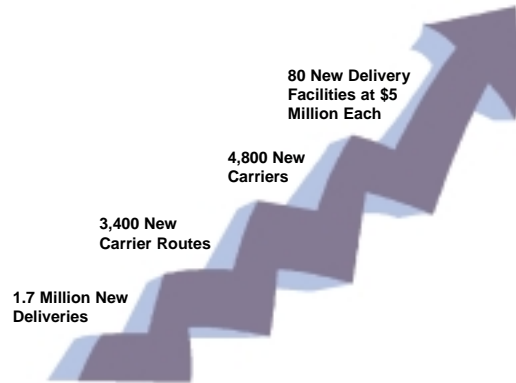
If the current interpretation of the universal service mission prevails, management has little control over the fixed infrastructure costs that this obligation entails. Maintaining present standards for speed, frequency and method of delivery, and access to services hamper any efforts to scale back the infrastructure in reaction to declining volume growth. Increased flexibility to make potentially unpopular, but necessary, decisions is ideal under all transformation phases.

COST OF THE NETWORK

Assuming no change in the universal service mission, the Postal Service must, on average, deliver \$1.85 worth of mail daily to each delivery address in order to support its current expenses. Simple projections of the future growth of postal expenses, using Consumer Price Index (CPI) and Employment Cost Index (ECI) estimates and calculating

possible delivery growth on the basis of household formation, suggest that the Postal Service will need to deliver \$2.46 of revenue per possible delivery per day, a 33 percent increase, to break even in 2010. On the surface, this increase does not appear to be dramatic. However, as mail volume growth continues to decline, revenue will still need to increase at a comparatively high rate to pay for the expanding network. The number of deliveries is driven by the universal service mission, and cannot be controlled. The arrow on this page is a graphic

ANNUAL DELIVERY NETWORK GROWTH



representation of the current annual growth experienced by the Postal Service as it meets its mandate to provide service to all addresses in America. The 1.7 million annual new addresses translate into an additional 500 deliveries for each of 3,400 new carrier routes. In turn, these new carrier routes require 4,800 additional carriers per year. To process the mail to be delivered, the Postal Service has to build 80 new delivery facilities at an average annual cost of \$5 million each. The Transformation Planning effort must help the Postal Service determine how it will meet these commitments in the future.

FINANCIAL CHALLENGES

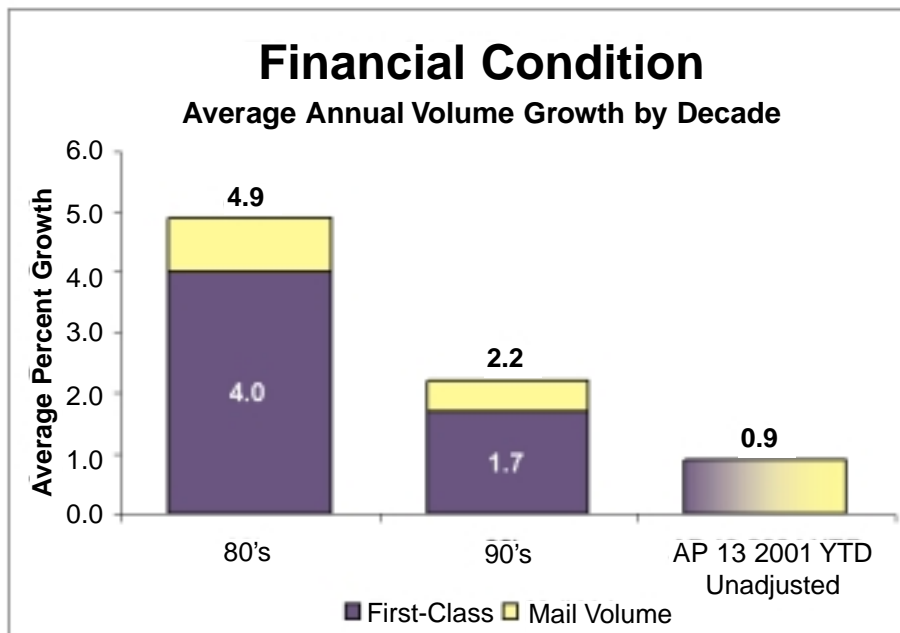
The Postal Reorganization Act requires that postage rates be set to cover costs. This has been interpreted to mean that the Postal Service break even over time. This constraint limits the organization's ability to generate internal cash flow. As a result, many required investments must be funded through debt. Presently, the Postal Service can increase revenue by adjusting the rates of its products and services through a ratemaking process that takes approximately 18 months.

How will the Postal Service finance universal service as volume growth declines and costs continue to rise?

FINANCIAL CONDITIONS

Despite the Postal Service's significant gains in efficiency and productivity through automation in recent years, Postal Service costs are rising faster than revenues. A diminishing growth rate trend of First-Class Mail has been made more severe by increased labor and fuel costs as well as structural changes in the American communications system, which are decreasing expected postal revenues. The recent softening economy has also had a negative impact. The costs of maintaining and servicing a growing universal delivery network have escalated. The universal service mission includes responsibility to serve many post offices and delivery points that are not self-sufficient.

From a financial perspective, the decline in the growth rate of First-Class Mail is alarming. The following chart illustrates the declining growth rate for both First-Class and total mail volumes.



As the chart depicts, annual First-Class Mail volume growth has slowed considerably during the previous decade, and there is no evidence that this trend is reversing. Looking at ten-year periods, from 1980 to 1989, First-Class Mail volume grew by 48 percent, which is an average annual increase of 4 percent. During 1990 to 1999, First-Class Mail volume grew only to 19 percent, an annual increase of only 1.7 percent. This is less than half the rate of growth seen in the previous decade. A comparison of fiscal year 2000 First-Class Mail volume data to fiscal year 2001 estimates shows that the declining growth rate is continuing. This monopoly product is of central importance to the Postal Service's bottom line because its revenues are sufficient to cover a significant portion of overhead costs. First-Class Mail comprises 48 percent of total mail volume but accounts for 69 percent of current postal revenues.

A number of customers and stakeholders fear that the volume trends illustrated above will result in continuing price increases, which in turn will drive volume lower, necessitating additional rounds of price increases and subsequent volume declines. At current relatively low price elasticities for most core products, this "death spiral" scenario may not be imminent. However, as the communications, advertising, and logistics markets become more competitive, mail volumes will become more price elastic, making this scenario a concern for the entire postal industry.

Total labor costs, meanwhile, continue to rise. In efforts to control labor costs, since fiscal year 1999, the Postal Service has reduced its career complement by 27,457 employees, a 3.4 percent reduction. Through September 7, 2001, it reduced work hours by 23.1 million below the prior year, while mail volume has grown 1.1 percent. Further, on September 7, 2001, the Postal Service announced a complement reduction of 1,300 administrative positions. Nonetheless, in fiscal year 2000 labor accounted for 76.5 percent of total Postal Service expenses. As reported in the 2000 Postal Service Annual Report, the growth in compensation and benefits for 2000 was 4.6 percent. Although the final fiscal year 2001 increase in compensation and benefits is not known, three factors in particular affected the growth of these costs in fiscal year 2001. First, increased grade levels for 240,000 city letter carriers were implemented in November 2000 as a result of a binding

arbitration award. Second, increases in the inflation rate during 2000 and 2001 resulted in higher than anticipated cost of living adjustment (COLA) payments. Finally, double-digit increases in health benefits costs added to the growth in compensation and benefits.

Through most of 2000 global oil prices also rose sharply, driving up refined fuel costs and the Consumer Price Index (CPI). The year 2000 CPI increase, the highest since 1990, triggered increased COLA payments for bargaining unit employees in accordance with contract provisions. In addition to higher fuel costs, the amount of fuel used by the Postal Service increased as the delivery network expanded by 1.7 million delivery points. Unlike energy-dependent companies in the private sector, the Postal Service can not respond quickly to these cost increases with temporary fuel surcharges, since all Postal Service rates are subject to review and regulation.

Postal Service management recognizes that even in difficult financial periods, its primary responsibility is to ensure that the American people continue to receive quality universal service at affordable rates. Addressing its revenue shortfall, the Postal Service acted early in fiscal year 2001 to freeze capital investment in needed new facilities and facility improvements³⁸, while pressing for additional efficiencies within the system. However, deferring these expenditures cannot be sustained over the long term and cannot substitute for needed revenue growth.

In January 2001, the Board of Governor's implemented under protest the Postal Rate Commission's recommended rate increases and submitted for reconsideration as required by law. In July 2001, the Postal Service determined that it was necessary to institute a modified rate increase. At this time the Postal Service anticipates a net loss of about \$1.65 billion for fiscal year 2001, substantially less than would have resulted without the improved productivity and rate modification. Total factor productivity for fiscal year 2001 is expected to reduce expenses by \$1.2 billion. However, on September 11, 2001, still faced with continued increases in transportation, labor, and health care costs and a highly uncertain economy, the Board of Governors announced the filing of a new rate case with the Postal Rate Commission. The case was filed on September 24, 2001.

FINANCIAL TRANSPARENCY

So that stakeholders and policy makers may follow the Postal Service's current and projected financial condition, a quarterly presentation of the Postal Service's financial results are provided on the Postal Service's website: www.usps.com.³⁹ The Postal Service's Fiscal Year 2000 Annual Report is also available on the website. In addition, hundreds of thousands of pages of official filings, which include extensive Postal Service revenue, cost, and pricing information, are available through rate and classification case filings posted on the Postal Rate Commission's website, www.prc.gov.

DEBT CEILING/CASH FLOW ISSUES

Under current law the Postal Service may increase its outstanding borrowing by up to \$3 billion annually, which includes a \$2 billion increase for capital investments and a \$1 billion increase to defray operating expenses. The Postal Service is subject, however, to a total debt limit of \$15 billion, which has been in place since fiscal year 1992, when it was

³⁸ A facility exception approval process was put in place to address emergencies, safety, and legal obligations.

³⁹ The financials are available on <http://www.usps.com/financials/> or on the Home Page of the Postal Service web site through "About USPS".

⁴⁰ Leasing is also used as a financing vehicle. The Postal Service enters into leases in the normal course of business. As of September 30, 2000, capital and operating lease obligations totaled \$9.7 billion.

raised from \$12.5 billion. Prior to fiscal year 1991, the debt limit had remained at \$10 billion since postal reorganization. The law also requires the Postal Service to notify the Secretary of the Treasury at least 15 days prior to offering debt obligations. The Secretary has a right of first refusal to purchase the Postal Service debt within the 15-day period or a commercially reasonable time period thereafter. Since 1974, the Postal Service has borrowed exclusively through the Treasury's Federal Financing Bank.⁴⁰

Following 1992, debt declined for five consecutive years, reaching \$5.9 billion at the close of fiscal year 1997. By the end of fiscal year 2000, however, debt had risen to \$9.3 billion and year-end cash totaled almost \$700 million, equal to approximately one week of payroll. Postal Service debt is projected to rise both in fiscal year 2001 and fiscal year 2002, and may total more than \$12 billion by the close of fiscal year 2002, bringing it within \$3 billion of the statutory limit. This projection assumes a continued freeze on construction of new facilities and no large net change in cash from the September 30, 2000 level.

The amount the Postal Service borrows is largely determined by the difference between its cash flow from operations and its capital cash outlays. The capital cash outlays are the funds the Postal Service invests back into the business for facilities and automation equipment. Capital investments are also necessary to maintain the existing infrastructure of facilities, equipment, and vehicles. Due to the linkage between borrowing, cash flow, and capital investments, discussion regarding an appropriate level of debt must take place within the context of plans for cash flow from operations and for capital investments.

The Postal Reorganization Act requires that postage rates be set to cover costs. This has been interpreted to mandate that the Postal Service break-even over time. The break-even constraint places an upward limit on the amount of cash flow that can be generated to pay for capital investments without borrowing. The fact that the Postal Service has not met its break-even objective (cumulative losses at the end of 2001 are estimated to be in excess of \$5 billion) has contributed to the rise in debt.⁴¹

The rate-setting process attempts to address prior year losses by including an allowance in each rate case to recover a portion of losses, currently set at one-ninth. Since the amount of the allowance is recomputed with each rate filing, the process will never allow the Postal Service to recover the losses in their entirety.⁴² Revenue growth driven by mail volume growth would, in theory, be the most effective way for the Postal Service to generate progress toward positive equity. Net income will translate into improved equity, dollar for dollar.

Sustained revenue and cash flow growth would not require borrowing to fund the capital outlays that are driven by the universal service mission and by the need to invest in cost-saving initiatives, including new technologies. In light of various technological and economic risks to mail volume growth, which create risks to cash flow, the Postal Service's capacity to service growing debt is highly uncertain.

Finally, access to credit is an important issue that will influence the long-term viability of the Postal Service. If the Postal Service were to borrow in the public bond markets, those markets' assessment and pricing of Postal Service credit would depend heavily on the Postal Service's structure and ties to the government. Numerous experts outside of the Postal Service have suggested that if the Postal Service became a private company, the focus of

⁴¹ It is important to distinguish between debt, which measures borrowed funds, and equity, which is equal to the government's \$3 billion capital contributions plus all net incomes minus all losses since reorganization. At the end of fiscal year 2000, Postal Service debt totaled \$9.3 billion and its equity totaled negative \$646 million.

⁴² The current practice has evolved over the course of a number of rate cases, involving input from the Postal Service, the Postal Rate Commission, and the Court of Appeals.

attention would change from the ability to rely on the United States government as a source of financial strength to include greater emphasis on the earnings power and capital structure of the privatized organization. The GAO's publication regarding the Tennessee Valley Authority (TVA) also supports this view.⁴³

The experience of government-sponsored enterprises, such as Fannie Mae and Freddie Mac, and the GAO's study of TVA, indicate that, when a borrower maintains a relationship with the government, that relationship tends to define the perception of the organization's credit in the market, although financial performance is also monitored. Rating agencies and investors would assume a reasonable probability that the government would step in to repay debts if the borrower failed to do so. In the case of a privatized Postal Service, the rating agencies would assess the fundamental ability of the organization to generate the cash needed to service its debt. Rating agencies would also look at the reliability of external financing sources, as well as other sources of liquidity inherent in the Postal Service's balance sheet. Nevertheless, the rating agencies would probably also continue to assess the Postal Service's public policy value and assume, to some degree, that the government could provide some means of repayment in the event the Postal Service was unable to fulfill its public policy obligations. Depending on the structure of the entity, this would be viewed as an "implicit" backing of the government, similar to the backing the rating agencies and investors assume for other government-sponsored enterprises, such as Fannie Mae and Freddie Mac.

The question has been raised whether the current \$15 billion statutory debt limit is appropriate for the Postal Service and, if not, what limit would correctly reflect the Postal Service's capacity to service debt without difficulty. As stated earlier, the Postal Service's capacity to service growing debt is not certain. That said, the issues associated with the Postal Service's debt limit are quite complex and benchmark comparisons with private sector companies are difficult, largely due to the Postal Service's break-even mandate and to private sector reliance on equity. Equity provides companies with a stable source of funds and also leads to a focus on creating value for shareholders by generating cash flow and profits. The debt ceiling and borrowing authority of the Postal Service will be analyzed in the Comprehensive Transformation Plan.

Increasing competition, shrinking market share in some product areas, growing diversionary threats, rising labor and fuel costs, and expanding service responsibilities combine to pose this stark question: *How will the Postal Service finance universal service as volume growth declines and costs continue to rise?* The answer to this question lies not only in financial structure, but in the Postal Service's ability to leverage and manage its extensive workforce.

How should the human capital requirement of the future Postal Service be met?

HUMAN CAPITAL CHALLENGES

This section discusses the human capital challenges facing the Postal Service. The term "human capital" refers to the skills and knowledge of the workforce and the ability of the organization to apply those skills and knowledge to meet corporate objectives. In a labor-intensive enterprise like the Postal Service, human capital strategies, such as workforce planning, training and development, compensation, and labor relations, are fundamental drivers of success or

⁴³ United States General Accounting Office Report to Congressional Requesters, GAO-01-540, *Tennessee Valley Authority Bond Ratings Based on Ties to the Federal Government and Other Nonfinancial Factors*, <http://www.gao.gov/new.items/d01540.pdf> (September 2001).

failure. When those strategies are constrained, by law, culture, or market pressures, the organization struggles.

CHALLENGES: GENERAL

Of the Postal Service's 778,000 career employees, approximately 694,000 (89 percent) are covered under collective bargaining agreements.⁴⁴ The four largest unions are the American Postal Workers Union (APWU), National Association of Letter Carriers (NALC), the National Rural Letter Carriers Association (NRLCA), and the National Postal Mail Handlers Union (NPMH). Both the size and strength of the labor unions are significant. Compensation and benefits account for more than three-quarters of total postal operating expenses,⁴⁵ making the financial health of the organization highly contingent upon the Postal Service's ability to manage its labor force.

The Postal Service is under intense pressure to control labor costs through a variety of means, including wage and benefit moderation, work rule changes and workforce planning flexibility. Successfully responding to increasing labor cost pressures, while simultaneously fostering workplace environment improvements, will undoubtedly continue to be one of the most significant challenges for the Postal Service. According to the GAO:

The Postal Service's human capital issues can be seen as part of a broader pattern of human capital shortcomings that have eroded mission capabilities across the federal government. The Postal Service and its major unions and management associations need to resolve long-standing labor-management problems that have hindered improvement efforts, including efforts to cut costs and increase productivity.⁴⁶

The Postal Service continues to develop and implement numerous strategies to facilitate organizational alignment and integration of human capital with the agency's mission, goals, objectives and core business strategies. Accomplishing that task, however, will likely be more difficult in the future if, as many predict, mail volumes stall or decline and cost pressures force reductions in complements, training budgets, and compensation-based incentives. In such a scenario, the incremental improvements of the past may no longer be sufficient.

Although it is not covered by most of the components of the federal civil service personnel system, the Postal Service shares some of its shortcomings. President George W. Bush's Management Agenda for 2002 could have been addressed to the Postal Service. The President said:

We must have a Government that thinks differently, so we need to recruit talented and imaginative people to public service... We'll establish a meaningful system to measure performance. Create awards for employees who surpass expectations. Tie pay increases to results. With a system of rewards and accountability, we can promote a culture of achievement through the Federal Government.⁴⁷

That is the environment the Postal Service and its Board of Governors have been trying to create. It is a significant challenge, however, to apply these business-oriented

⁴⁴ Labor Relations Department, "Summary Number of Bargaining Unit Employees" (Washington DC: U.S. Postal Service, September 2001).

⁴⁵ United States Postal Service, 2000 *Annual Report*.

⁴⁶ U.S. Postal Service: *Transformation Challenges Present Significant Risks* (GAO-01-598T) Testimony of Comptroller General David Walker before the Committee on Government Reform House of Representatives, April 4, 2001: p 15. (Appendix A.)

⁴⁷ "The President's Management Agenda, Fiscal Year 2002," p 11

philosophies to a human capital infrastructure that is constrained in ways that most businesses are not.

WORKFORCE PLANNING: GENERAL

The Postal Service is facing major marketplace challenges as it enters the 21st century. As the previous section indicates, mail volumes may stall or decline but the value of the mail could increase if the Postal Service is considered a crucial component of its customers' communications, advertising, and logistics networks. In this environment, workforce planning efforts must focus on flexibility, because total workload requirements are decreasing and becoming more difficult to predict and on recruitment and skills development, because the nature of the work is becoming more specialized and strategic and less repetitive/transactional.

As a result, the Postal Service is reexamining its focus and its organizational structures, and is streamlining where appropriate. Planning efforts involve identifying the skills and talents that will be necessary to accomplish the Postal Service mission, while determining how to redeploy talent, attract the skills that do not currently exist, and, as necessary, divest labor costs associated with redundancies.

While the overall number of postal employees will continue to be reduced through attrition, this reduction will not leave the Postal Service with the exact skills sets necessary to perform its mission. Finding ways to realign the existing workforce to meet complement needs has not always been efficient. Mismatches in this area can strain the continuity of core business. Despite the continued need to streamline operations, the Postal Service must implement recruitment strategies for positions that require a specialized skill or talent widely sought in private industry and by public sector employers.

Complement reduction efforts to control labor costs have required implementation of a Reduction-In-Force (RIF). Implementing organizational changes involves a certain degree of complexity, since the Postal Service is required to follow certain statutory requirements. When using RIFs as a complement reduction tool, specific process steps must be followed in order to comply with applicable laws and regulations. A RIF, while providing a systematic approach to streamlining complement where needed, is a lengthy process that is disruptive to the organization, and does not necessarily provide sufficient flexibility when making necessary organizational changes. Other options for cost control exist.

Outsourcing as a response to cost pressures is an option the Postal Service can and will pursue when appropriate. Past experience has shown that flexibility in using this tool is limited. A final element of human capital flexibility is less tangible; it is the extent to which the culture of an organization tolerates, or even promotes change. For many reasons tied to the potentially conflicting blend of public policy and business objectives, its break-even constraint, and the public importance of the services it provides, the Postal Service is risk averse. If the markets in which the Postal Service operates begin to change dramatically, the culture of the organization must change as well.

Even while the Postal Service is reducing its workforce, it will need to recruit people with specialized skills and talents from a diverse applicant pool to help the organization respond to increasingly sophisticated customer requirements. It is hampered in this effort, however, by a number of constraints: salary caps restrict compensation; stock options are not available; and the organization suffers from the perception that its very size and association with government make it a less than promising place to launch a career.

In the area of skill development, the Postal Service has implemented state-of-the-art training and development programs, such as the Advanced Leadership Program, the Postal

Service Training Network (PSTN), eLearning, and other residential and distance learning efforts. These training and development strategies will need to continue at appropriate levels for on-the-job training, to both develop talent and leadership that parallels succession-planning requirements, and to supplant the loss of talent through attrition and complement reductions. Funding these skills development programs will be a challenge.

WORKFORCE PLANNING: EXECUTIVE AND ADMINISTRATIVE EMPLOYEES

The Postal Service anticipates that technological improvements, particularly in field operations and administrative functions, and adoption of efficient shared services models for administrative functions will result in complement reductions in non-bargaining supervisory, administrative, and other management positions. Workforce reduction efforts are thus focusing on positions where workload has diminished because of decreased mail volume, technology substitution, work consolidation, or economic downturn.

Approximately 39 percent of the Postal Service's non-bargaining workforce will be eligible to retire through year 2005. This percentage does not account for those employees who may leave for reasons other than retirement. With this potential exodus, planning efforts have been focused on identifying and developing talent to fill critical positions. The Postal Service has developed both executive and managerial core competencies and has addressed and communicated a common and consistent understanding of what skills are needed for internal career development.

COMPENSATION

Prior to 1970, postal compensation was identical to that found in the rest of the federal government. The Postal Reorganization Act, however, implemented a general standard of pay comparability to the private sector and a new system of collective bargaining for determining changes to bargaining-unit compensation within the comparability standard. In several key respects, however, the statute retained ties to the civil service.

Several provisions of the Postal Reorganization Act linked postal compensation directly to federal practices. For example, the maximum salary is tied to Federal Executive Level I, the same level as members of the President's Cabinet. In spite of salary caps and other constraints, the Postal Service has pioneered pay-for-performance programs (variable, merit, and recognition pay) in the federal government and in this way has driven substantial organizational success by aligning compensation with performance. However, the unfamiliarity of these programs in a break-even environment can invite misunderstanding and misgivings within the federal oversight community.

Compensation rules for labor that existed prior to the reorganization were preserved unless changed through the collective bargaining process. If either party in the collective bargaining process proposes changes to which the other party will not agree, the issue is left to an arbitrator. Arbitrators in the collective bargaining process have generally been averse to making major changes to current practices. The challenges inherent in the collective bargaining process for bargaining unit compensation are further discussed later in this section.

Other than the territorial allowance for employees outside the contiguous 48 states, nation wide pay scales do not allow for differentiation of pay by local labor markets. Certain postal benefit plans are tied by law to federal programs, e.g., retirement, which

restrict the Postal Service from designing cost-effective programs to serve strategic organizational needs. Despite its limitations, the Postal Service has been in the forefront of the federal community in making compensation changes. Government Executive magazine has characterized the Postal Service as a leader in tying pay to results. Although the Postal Service has made progress in meeting its compensation challenges, opportunity still exists for improvement.

WORKFORCE PLANNING: LABOR

While every indication is that the need for administrative staff will continue to diminish, internal and external environmental situations will demand that workforce plans also include replacement strategies for certain bargaining unit positions. Operating requirements will demand a degree of flexibility in using the existing workforce on assignments that are critical to the Postal Service mission. Technological improvements in processing operations have decreased the need for certain clerical positions. However, to maintain the universal service mandate, maintain operations, and meet the challenge of ever increasing points of delivery, certain skill sets will be critical. The Postal Service will need to address cost efficient ways to move people from positions that are no longer necessary to positions that remain critical. Management will need to monitor attrition projections for bargaining unit positions where a specialized skill and/or license is required. Since specialized skills, especially in the area of maintenance, are also in demand in both private industry and the rest of the public sector, the Postal Service will still have recruitment challenges.

COLLECTIVE BARGAINING

The current procedure for final and binding arbitration ensures that a resolution to a dispute will occur without any disruption to the operations of the Postal Service. The process allows for fact-finding and mediation that can produce an agreement between the parties. In addition, the primary positive feature of this procedure is that it functions as an alternative to strikes and lockouts, thus avoiding the economic damage that results from such actions.

The current binding arbitration procedure also presents a number of challenges for the Postal Service. By its very nature, interest arbitration puts decision making in the hands of a third party arbitrator. Unlike the parties to the labor agreement, the arbitrator does not have a personal stake in the outcome of a decision. Neither does the arbitrator have to be concerned with the long-term viability of the organization or the parties' ongoing relationship. In addition, the Postal Service bargains with a number of unions at separate, independent negotiations. This can lead to inconsistent results, which hamper management's flexibility or increase costs. A gain made by one union may be used to "whip-saw" the organization and gain similar provisions in other units.

Throughout the collective bargaining history of the parties, a number of improvements have been achieved utilizing the binding arbitration model. These changes include:

- Expanded use of part-time employees in the city carrier craft to increase workforce flexibility, allowing management to better staff and schedule resources consistent with workload.

- Doubling the percentage of part-time employees in the clerk craft, which will also increase flexibility.
- Limited ability to lay off employees.
- Expanded flexibility through the creation of temporary non-career transitional employees.
- Reduced Postal Service health benefit contributions.
- Reducing somewhat the wage premium gap that has existed for more than twenty years. That progress has been largely offset by a continuing benefits premium, so that when viewed in the context of total compensation, there has been only a modest closing of the total compensation premium.

While the Postal Service has had a number of successes in making interest arbitration more flexible, from management's point of view there have also been instances of unfavorable awards for the Postal Service. The potential financial significance of some of these awards is not nearly as visible as are other aspects of postal operations.

Examples of the major decisions that have resulted from recent arbitration are:

- An independent arbitrator upgraded all city letter carrier positions in an interest arbitration award, which occurred as a result of the last negotiations with that union. That award was a significant impediment to subsequent settlements with other unions wanting an upgrade like the NALC.
- An earlier, separate interest arbitration award upgraded utility carriers, who deliver on five different routes.
- NALC transitional employees received COLA as a result of the 1992 interest arbitration.
- COLA provisions have continued in the Postal Service's labor agreements despite prodigious efforts to eliminate them.

Under current law, the Postal Service's strategy is to seek positive change while maintaining the beneficial aspects of the existing procedures. The Postal Service believes that realistic changes can be made that will enhance the current collective bargaining process. These changes can streamline the current arbitration procedures by imposing standards for the selection of a neutral party and by shortening the arbitration process. Dramatic change proposals that cannot be accomplished are of no value.

Human capital challenges are just one component of a comprehensive list of issues that must be addressed in developing a transformation plan. The next section addresses operational, financial and human capital strategies that the Postal Service might examine for each of three parallel phases of postal transformation.

TRANSFORMATIONAL PHASES

SECTION 6:

TRANSFORMATIONAL PHASES

Given the challenges outlined in Section 5, how should the Postal Service be transformed to best serve its customers? This *Outline for Discussion* outlines three possible phases:

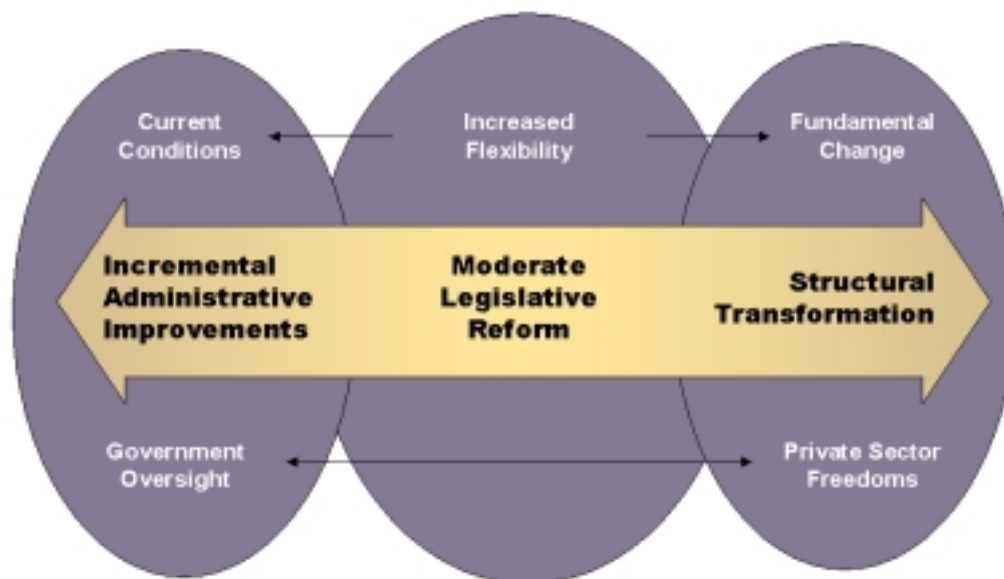
How should the Postal Service be transformed to best serve the American public and the mailing industry?

- *Incremental Administrative and Operational Improvement* – Actions that can be taken to improve postal services and postal finances without changes to the current law.
- *Moderate Legislative Reform* – Statutory changes that provide the Postal Service more pricing and operational flexibility in exchange for incentive regulation to moderate price increases and, potentially, a reduction in the scope of the monopoly.
- *Structural Transformation* – A fundamental change in the mission, obligations, governance structure, and/or regulatory framework of the Postal Service.

As a practical matter, transformation of a large institution is likely to take place one step at a time. It is logical, therefore, to think of these phases as sequential. Many stakeholders, however, believe that this approach could delay critical, long-range transformational decisions that must be made now. This *Outline* therefore considers these options as “parallel phases” and invites stakeholders to consider all three as potential solutions to current postal challenges.

Within each of these phases there is a range of alternative approaches that might be taken to address issues such as the scope of universal service or the governance structure of the Postal Service. For example, fundamental structural transformation can take many forms, as there are transformation models from other Posts and from other regulated industries that range from incorporated government entities to fully privatized businesses. At issue is what represents the best approach to take in shaping the postal model of the 21st century. These alternatives must be considered by the Postal Service Board of Governors and management, the Administration, Congress and, ultimately, by the mailing community and the American people.

THE BROAD RANGE OF POSSIBLE CHOICES IS ILLUSTRATED BELOW.



For each of the three phases, the postal community must consider its core assumptions and assess strategies for operations, finance, pricing and human capital. All of these components are interrelated, and all can be defined only in the context of the broader question of how the Postal Service should be transformed to better serve its customers and constituents.

PHASE ONE: INCREMENTAL ADMINISTRATIVE AND OPERATIONAL IMPROVEMENT

This phase considers business and operational improvements within the legal and public policy framework that exists today. The Postal Service is already taking action, using existing authorities to reduce costs, increase efficiency, and generate new revenue.

ASSUMPTIONS

Delivery scope and frequency, service standards, retail access, uniform rate requirements, and the security of the mail will remain as they are today. The Postal Service will continue to focus on core products and services and enhancements designed to improving reliability, ease of use, and tracking. Major new product offerings are not expected under this phase. Declines in volume or unexpected increases in costs will be offset by increases in price and continued investment in costs reductions and efficiencies.

OPERATIONS

Cost reductions and increased efficiencies are the primary focus of this phase. The Postal Service has achieved productivity improvements sufficient to provide universal service while keeping rate increases generally in line with inflation despite substantial workload

growth. To ensure success in a baseline scenario, the Postal Service has developed some bold actions to take within current constraints. Some examples of these plans include:

Worksharing: The Postal Service will continue to look for opportunities to partner with the mailing industry to reduce costs through pricing incentives and classification changes. Recognizing that opportunities to reduce internal mailer production costs can positively impact the volume of mail, stakeholders have identified mailing requirements changes that can reduce both Postal Service and mailer costs. In addition to new and enhanced discount programs resulting from the recently announced rate filing, there are plans for a significant product redesign effort designed to recognize changing customer needs and to take advantage of expanding mailer capabilities. In addition to providing products that better meet customer requirements, the Postal Service will endeavor to "rationalize" the classification schedule to motivate mailers to produce mail that is compatible with the most efficient processes.

Capital Investment: The Postal Service will continue to pursue opportunities to improve already highly efficient letter operations. For example, the development of the Postal Automated Redirection System (PARS) will use advanced information technology to intercept undeliverable-as-addressed mail earlier in the sorting process and thus reduce the number of handlings and associated costs. The Postal Service will also focus investments on other labor-intensive operations. The latest generation of flats sorting equipment that provides additional capacity and offers substantial increases in productivity over the older generation of equipment is being deployed nationally. Plans will be implemented to add automation capability and automatic feeders to those flats sorting machines designed to process over-sized flats and to add automated carrier delivery sort features for flats similar to those successfully implemented for letters.

Allied operations, those not directly involved in individual piece distribution, are some of the fastest growing cost centers and also targets for capital investment. Currently under development is the next generation of the small parcel and bundle sorter that will incorporate automated capabilities for productivity gains. Also being developed are various material handling systems designed to reduce the dependence on manual labor for moving mail within processing facilities. Examples of systems currently under development include a Direct Connect System that will link canceling and barcode sorting equipment, and a Universal Transport System capable of moving letter trays, flats tubs, sacks, and individual parcels throughout processing facilities.

Network Consolidation: While continuing to look for opportunities to streamline networks through consolidation initiatives, the Postal Service is committed to a comprehensive examination of all distribution and transportation networks. Given the complexity of those networks, efforts in this area will take time to produce results, but significant cost savings opportunities will be identified. In addition, aggressive transportation strategies to move more mail onto a shared surface network and improve overall utilization of the transportation assets are being pursued.

Productivity and Growth Management: The Postal Service has undertaken a comprehensive cost reduction program which focuses on identifying best practices within specific operations, creating standardized procedures within those operations and then requiring use of those standardized processes at all facilities. Additionally, the Postal Service is

aggressively pursuing the development of information systems designed to provide line managers with the metrics and feedback mechanisms necessary to manage operations.

FINANCE

Under this phase, the Postal Service will focus on financial strategies that are permitted within the existing legislative framework. These strategies are designed to reduce administrative costs, generate sufficient income to recover prior year losses (currently estimated at \$5 billion through fiscal year 2001), and increase cash flow. The greater cash flow could be used toward capital investment and debt reduction. For example, the Postal Service is considering providing administrative services to field and headquarters organizations through consolidated shared services centers. This approach will standardize and automate administrative functions, reducing redundancy and transaction times and therefore costs. As the Operations section above indicates, the Postal Service will also work aggressively to reduce operating costs. The objective of these bold actions – and of price increases, if warranted – will be to earn sufficient net income to recover prior year losses and produce the cash flow necessary to fund certain investments and reduce debt.

PRICING

Pricing will follow the current regulatory structure. The revenue requirement and prices will be determined by the Board of Governors, subject to review by the Postal Rate Commission. Small changes in rates and classifications will continue to occur with each rate filing. The Postal Service might also initiate significant product reclassifications as customer requirements and market conditions warrant. There is considerable discussion in the stakeholder community regarding the extent to which the ratemaking process may be streamlined or otherwise improved without legislative change, but at this time there is no consensus regarding how much flexibility exists in the current regulatory framework.

Under existing authority, the Postal Service could pursue a number of specific pricing initiatives, for example:

- **Introductory pricing:** New products and services (e.g., delivery confirmation and CONFIRM) could be introduced through initial rates that ease market entry and help create market interest.
- **Transportation container rates:** Zone transportation pricing would allow mailers to co-mingle various mail classes on one container and pay for the transport of that container to destinating facilities.
- **Phase-in pricing:** Price increases could be phased in over time for business mailers giving more predictability to price increases.
- **Limited negotiated service agreements:** Through experimental rate cases, the Postal Service could pursue pricing agreements for specific large volume mailers. This could be done through the reclassification process, assuming the rate change was cost-justified.

HUMAN CAPITAL

The implementation of incremental administrative improvements will be a framework within which the Postal Service will continue to implement a series of administrative

actions to continue to reduce costs and improve efficiency beyond the historic high levels that have been achieved in recent years. Respect for the dignity of individuals, valuing diversity and an emphasis on continuous improvement of safety performance will continue to be core values and the focus of the organization. Significant restructuring has already been undertaken to reduce administrative costs and improve the efficiency of field operations. At the operating level, in the absence of authority to determine workforce changes except through the current collective bargaining process, more contracting out of services might be explored.

The existing system encourages continued exploration of shared service arrangements that promise to reduce costs and to improve administrative efficiency. Opportunities to reduce costs through investment in e-Service arrangements to automate the backend processing of administrative functions will increase. Such arrangements are currently being explored in the areas of benefit administration. The outsourcing of functions such as EEO complaint investigations will continue on a step-by-step basis. Other opportunities to reduce costs such as increased attention to attendance management will continue to be refined.

Administrative reductions will take place utilizing Reduction-In-Force (RIF) strategies to align workforce with workload. Training and development programs will be similar to those in place today that focus on advanced leadership development, supervisor training, and the reestablishment of internship programs.

Statutory salary caps will still exist, but might be relaxed within the constraints of maximum federal compensation limits. This relaxation could help the Postal Service attract and retain senior executives. Pay for performance will likely remain limited to non-bargaining unit personnel. Efforts to reduce labor compensation premiums relative to the private sector will continue through the collective bargaining process that is in force today. Benefits will still parallel other federal programs, though some moderate changes in health benefit contributions or annual and sick leave reform could occur.

The right to strike will not exist. Craft employee pay will still be based predominantly on steps and grades, without regard to locale. Binding arbitration will continue with moderate improvements. One proposal for modification of the arbitration process has included the utilization of one mediator, selected by the Secretary of Labor, to create a mediation-arbitration combined process. With this improvement, the length of the arbitration process might be shortened to reduce the uncertainty experienced under the current system.

PHASE ONE IMPLICATIONS

Early discussions with stakeholders have highlighted some strengths of this phase, but only if volumes and contribution continue to increase:⁴⁸

- The American public will continue to receive universal service as currently defined.
- The nonprofit mailers will continue to receive preferred rates.
- The Postal Service will be a stable employer.
- The Postal Service will remain a major government purchaser for suppliers.

⁴⁸ This discussion of the implications of these phases is not meant to be definitive. By including this summary of the pros and cons that have emerged from early discussions with stakeholders, the Postal Service seeks to encourage comment that will guide analysis of the different phases.

- The Postal Service will continue to support the mailing industry.
- Prices will be determined using the familiar rate making process.

Although the Postal Service is already implementing plans to increase efficiency, some stakeholders believe that the current model is not sustainable in the long term if mail volumes decline because of electronic diversion, increasingly aggressive competition, and/or weakening economic conditions. The following are possible negative implications of this phase:

- Increases in per-piece costs resulting from declining volumes and fixed universal service obligations could necessitate service reductions and large rate increases.
- Revenue shortfalls could limit investment in plant, equipment, and information systems. Future service and productivity improvements would be placed at risk, threatening price stability.
- Sharp declines in mail volumes could result in significant job losses in the Postal Service and the mailing industry.
- Mail volume diversion could result in “residual” mailers paying for the remaining fixed costs of the universal service infrastructure.
- The Postal Service might reach its legal debt limit quickly and then fail to make current payments such as salaries.
- Direct government subsidies might be required.
- Adversarial labor/management relations could result from the required aggressive cost-cutting policies.
- Complex regulatory constraints on product development and pricing would continue to make it difficult for the Postal Service to react to changing customer requirements.

PHASE TWO: MODERATE LEGISLATIVE REFORM

This phase includes moderate legislative reform designed to improve the flexibility and competitiveness of the Postal Service. Universal service may be more strictly defined. Governmental controls would allow for increased Postal Service management discretion over the distribution and transportation network. Additionally, this phase might include separate regulatory frameworks for competitive and market dominant products. Non-postal or competitive products might be offered through newly created business units, initially owned by the Postal Service.

How can the future postal system become more commercial?

In addition to offering its enhanced core products, the Postal Service might also look for opportunities to enter complementary markets, such as logistics. If volume diversion were to accelerate, such investments in complementary markets would increase in efforts to combat revenue erosion due to substitution.

Potential transformational strategies associated with this phase are found below.

OPERATIONS

Implementation of enhanced productivity and network optimization efforts discussed in Phase One will continue. In addition, the Postal Service would pursue opportunities to push the current limits on dramatic change. Each of the following depends to a greater or lesser degree on overcoming real or perceived constraints from the universal service obligation or related legislation.

Networks: In order to control fixed costs as volume declines, it is necessary to have the capability and the flexibility to optimize the distribution network. The Postal Service must be able to logically determine the number, size, location, and role/function of all plants and other facilities in the network and make significant changes where necessary. This would require enhancements to Postal Service information systems, labor flexibility in moving or laying off workers, and the ability to close or downsize facilities fairly rapidly.

Transportation network optimization is also a key strategy. The ability to successfully move mail from air to surface transportation depends ultimately on the Postal Service's ability to manage and rationalize service standards.

Service Standards Revision: The current standards for speed of delivery for various classes of mail require some very costly procedures in collecting, sorting and transporting mail. In order to ensure that the most cost efficient methods possible are consistently applied, those standards need to be reviewed on a regular basis relative to customer requirements. The flexibility to make significant targeted changes to those standards would be critical to successful cost containment. The ability to implement changes as drastic as eliminating overnight service, adding days to current standards, or reducing service commitments in specific geographic locales would be required. This ability will ensure not only lower costs, but also promote better consistency in the service provided.

Capital Investment: Automation of letter mail has reduced the cost of that mailstream significantly. There are additional automation or mechanization projects that have potential for further reductions in the cost of processing other mailstreams. The restrictions on capital available for investment have hindered efforts to test and implement some of these cost reduction projects.

Delivery: Some stakeholders have suggested that delivery frequency would need to be addressed. Current costs and a major portion of the future growth in costs are directly related to the requirement to deliver mail to every address every day. The ability to approach this requirement rationally and determine the most cost efficient frequency for delivery based on actual customer need would serve to reduce costs significantly. This would suggest case-by-case analysis based on geographic factors rather than a standardized approach. Models already exist for providing efficient and effective residential and commercial services that differ according to local need.

Stakeholders, likewise, have discussed delivery methods. Current costs and a major portion of the future growth in costs are directly related to existing methods of residential delivery. The various delivery services, for example post office boxes, rural delivery or city delivery, vary widely in the system costs they incur. Similarly, the differing residential deposit sites such as door slots, curblin boxes, or centralized boxes have significantly different costs that have been a well-documented part of fixed costs. The ability to require

changes to currently established methods of delivery based on specific customer need as well as cost efficiency would allow substantial improvements in cost control.

Access: Stakeholders have also discussed the potential need to redefine access requirements. Fixed costs are directly related to the requirement to maintain local post offices in areas where it is not cost effective to do so. The Postal Service would implement strategies that make small post offices more self-sufficient. Additional government/community services might be provided for a fee and commercial services such as banking may be included as well. When self-sufficiency is not possible, alternative methods of ensuring access to postal products and services would be implemented before offices are closed. Distance or density criteria might be utilized in lieu of one-for-one community post office requirements. New technology and developing business alliances could provide excellent access to products and services without maintaining expensive infrastructure. The ability to utilize alternate methods to ensure that all customers have convenient access would be critical to managing fixed infrastructure costs in a period of declining volumes.

Outsourcing: The Postal Service would also examine leveraging outsourcing capability. There are numerous identified and potential opportunities to contract out specific tasks or complete functions (from particular janitorial services to the entire operation of processing plants) to avoid the costly premiums in Postal Service wages. Increasing cost effectiveness would depend on the ability and flexibility to make rational business decisions regarding non-traditional outsourcing strategies.

FINANCE

In this phase, the Postal Service's financial objective would be to maximize profits given the universal service obligations and regulatory constraints, e.g., price caps, defined in the reform legislation. The Postal Service would use its profits and cash flow to reinvest in its operations, reduce its debt, and perhaps purchase equity in related businesses, for example, through joint ventures. If new legislation permits, the Postal Service might also create an independent business unit for either competitive products or competitive operations (e.g., the transportation network). If this approach were taken, separate, audited accounts would be required to prevent cross-subsidy from monopoly to competitive businesses. Postal employees might be offered an equity stake in this independent business unit through an Employee Share Ownership Plan (ESOP). The Postal Service would use additional freedoms granted in the envisioned reform legislation to restructure its balance sheet, using private-sector financial instruments as appropriate.

PRICING

The pricing mechanism would be changed to allow greater flexibility, for example, by using price caps as opposed to the current cost-based methodology. Price caps could tie maximum price increases of bundles of products to specific market indices (e.g., the Consumer Price Index). Typically, productivity factors are included in price caps requiring efficiency gains on the part of the Postal Service. Major product reclassification would occur to encourage mail preparation changes and to facilitate process standardization and productivity improvements. Pricing and classification flexibility would encourage accelerated product introduction and innovation and the development of customer-specific

product solutions. Contract pricing could be pursued more aggressively under this phase allowing the Postal Service to customize prices for key customers.

The regulator would continue to play a role in rate changes, albeit in a less direct way than at present. The regulator would determine relevant public policy criteria and rate hearings would only be held if the regulator received a credible complaint that the Postal Service had not adhered to those criteria.

HUMAN CAPITAL

Workforce strategies that would be implemented in a moderate legislative reform phase would be similar in many respects to those implemented in Phase One. Administrative authority and the collective bargaining process would be used to seek additional opportunities to improve efficiency. Some stakeholders have suggested that even moderate reform of such limits as pay caps and the use of financial incentives would have a significant benefit in contributing to performance.

Under existing law there is an opportunity to provide significant bonuses for such achievements as major productivity improvements. But the public sector management framework that has governed the Postal Service has limited the use of such authorities. Under moderate reform, explicit authorization for the use of such tools could be clarified.

Similarly, ESOP plans could be authorized under the framework of moderate reform. If reform permits the creation of a separate private corporation for non-postal products, as has been suggested in some reform proposals, more market-based workforce strategies that would create incentives for management and the work force could be implemented in such a private sector framework.

One of the proposals that has been suggested in past reform efforts has been the creation of legislative guidance for the President in the selection of the Board of Governors. Stakeholders have commented that Board membership in some public enterprises requires specific types of experience, such as experience managing large corporations.

Finally, it should be noted that there has been limited attention given to legislative changes that would address human capital in the discussion of reform during the past five years. Comments from a number of stakeholders have suggested that there will be a need for more fundamental changes in the Postal Service model if there should be reform in the current human capital policies and procedures.

PHASE TWO IMPLICATIONS

Early discussions with stakeholders have highlighted some strengths of this phase:

- The American public would continue to receive universal service.
- These reforms would increase market discipline and reliance on new product development and innovation.
- The Postal Service would continue to be a stable employer.
- The Postal Service would remain a major purchaser for suppliers.
- The Postal Service would continue to support the mailing industry. Prices would be more predictable, with smaller, more frequent increases.
- Pricing flexibility could be used to manage volume and workload, thus optimizing the network and reducing costs.

- Employees affected by mail volume losses could be retained and re-trained if the Postal Service enters new markets.

The following are possible negative implications of this phase:

- Increases in per-piece costs resulting from declining volumes and fixed universal service obligations could necessitate service reductions and large rate increases if new revenue streams were not found. Among such service reductions could be closure of many small post offices and a reduction in the number of delivery days for residential customers.
- Volume diversion could result in “residual” mailers paying for the remaining fixed costs of the universal service infrastructure.
- Some stakeholders believe that none of the moderate reform changes are radical enough to respond to the market conditions that have already begun to transform the mailing industry.

PHASE THREE: STRUCTURAL TRANSFORMATION

There are a number of different ways in which fundamental legislative reform could be used to reconstruct the basic postal model. The Postal Service might, for example, become more like a traditional government agency and less like a business, with an even stronger public service mandate and federal subsidies approved to meet the expanded public policy mission. Conversely, new legislation might further the transformation process begun in 1970, perhaps to include privatization as has occurred in the postal sectors in Germany, the Netherlands, and elsewhere around the world. A privatized Postal Service could include ownership by employees, the government, and the American public. Still other options may be suggested during the comment and analysis phase. Some observers have suggested that a restructured postal system could consist of a core monopoly service, possibly supported by appropriations and competitive private franchised services. These and other concepts will be analyzed.

Can a privatized Postal Service do a better job?

ASSUMPTIONS

There is much debate regarding the most effective method of ensuring universal service in an increasingly competitive postal marketplace. One possibility would entail the government contracting with the Postal Service and/or other organizations to provide retail and delivery services in unprofitable markets, should market-based prices in such areas threaten the universal service obligation. With this model of direct government compensation for the universal service obligation, the Postal Service’s current monopoly might prove a hindrance, since some believe that monopoly protections require regulatory oversight. As a result, the monopoly protections and regulator constraints might be phased out, creating a level playing field in which the best service providers prevail in a competitive market.

With monopoly protections eliminated, the marketplace would ultimately define the product and service offerings. Service options would likely be more complex, sophisticated, and customized to narrower market segments.

OPERATIONS

The operational changes discussed in Phases One and Two would continue as the Postal Service implements cost control and productivity improvements. Operations would employ state of the art business practices (e.g., cost accounting systems, additional investment in automation, and increased flexibility in managing work hours and productivity) to make the Postal Service competitive in a private sector environment. Once the requirements of a new structure are defined, operations would be modified and enhanced to provide cost efficient new products and services demanded in the marketplace.

FINANCE

A privatized Post would raise its revenue through the sale of market-based competitive products and services. Shareholder fiduciary interests would determine standards of performance. The ability to raise capital would depend on the market's assessment of the Postal Service's business prospects. Factors such as the Postal Service's remaining or perceived link to the government, the presence of subordinated capital, the degree of liquidity within the balance sheet, existing leverage within the organization, and projected profitability would all factor into a credit rating for the organization and, in turn, the performance that shareholders would require. The Postal Service would have broad investment discretion subject to the direction of its Board of Directors, like any other private entity.

In a privatization scenario, the financial objective of the Postal Service would be to maximize shareholder value. Financial strategies would contribute to that goal. In particular, like UPS's 1999 Initial Public Offering (IPO), the privatization itself would raise capital that could be invested in operational improvements and competitive ventures, and would allow the Postal Service to purchase other companies with its own stock. In this phase, the Postal Service might utilize its access to capital to underwrite new financial services to its customers, for example, extending credit terms to business mailers based on the value of their product in the mail stream. It might invest in companies that bring core competencies the organization needs to better serve its customers. It might also sell components of its infrastructure, for example some post offices, to companies that could improve the profitability of the operations.

PRICING

Pricing would be set in response to market forces, consistent with maximizing shareholder value, and subject only to laws and regulations of commercial entities (e.g., anti-trust). The Postal Service would set prices based on conditions in the market place (external conditions) rather than relying strictly on costs (internal considerations). Factors such as customer value, the competitive environment, and product and corporate strategy would play fundamental roles in pricing decisions, with cost being treated as a threshold factor. Pricing flexibility in this phase provides the Postal Service with a myriad of pricing options, including:

- Price discrimination through dynamic pricing whereby prices are segmented based on different customers and changing market conditions (e.g., as practiced by the airline industry).

- Bundled pricing whereby Postal Service products are bundled to increase customer value. An example would be pricing catalog mailings together with the parcels those catalogs generate.
- Gain-sharing whereby the Postal Service's prices are partly determined by the impact of its services.

HUMAN CAPITAL

Corporatization and privatization would, some have argued, provide the Postal Service with needed flexibility to employ the right people in the right place at the right price. A "corporatized" postal service would have greater managerial freedoms that would permit the enterprise to function in the manner of private corporations. There would be greater freedom to adjust the workforce to meet volume changes and to address problem workers. Layoffs and other separation options could be used to trim the workforce commensurate with resource requirements. Training and development would likely expand to meet the competitive requirements of a changing market. Investments in human capital would become increasingly critical to competitive success.

There would be no salary caps. The Postal Service would have the flexibility to offer numerous incentive options, including employee stock ownership plans and a variety of benefit option packages, which should improve the enterprise's ability to attract and retain talent. Pay for performance plans might be possible enterprise-wide. The Postal Service and the labor unions might be freed from binding arbitration to negotiate voluntary agreements that better balance business with employee needs. Some have suggested that the reforms that might be possible under a restructured Postal Service would give the unions the right to strike, in which case management would have to be prepared to sustain operations at the appropriate level.

Whether or not Phase Three would fundamentally alter the interest arbitration process is an open question. Some stakeholders have suggested that the current process with modifications could serve the institution well even in the event of market change. But there is no question that a restructured postal system would have to have greater flexibility to adjust to changing markets. The size and the skills of the current workforce will have to change over time as is the case in private enterprises throughout the economy. As volume changes require adjustment in the numbers of employees and in the mix of skills, the question of how to protect employee rights while increasing the capacity of the organization to respond to market pressures will become a rising priority.

PHASE THREE IMPLICATIONS

There are some notable strengths related to this option, which were apparent in the discussions with stakeholders:

- Market discipline would drive increased efficiency.
- The Postal Service would continue as a competitive employer, even in a rapidly changing market.
- The new enterprise would be freed from most regulation and oversight and become subject to commercial laws.
- Customers might benefit from competition in a deregulated postal marketplace.

The following are possible negative implications of this phase:

- Universal service would be more difficult to maintain.
- Prices could increase substantially for high cost areas if uniform rate restrictions were abolished.
- There would likely be significant pressure on above-market wage rates.

STAKEHOLDER INPUT

SECTION 7: STAKEHOLDER INPUT

To build a partnership with Postal Service stakeholders in the development of the Transformation Plan, the Postal Service has adopted a multi-step approach to gaining stakeholder input. Step One has included informal meetings and discussions with postal stakeholders: employees, mailers, suppliers and policy makers. Input from others beyond these informal meetings will be sought in Step Two, following the publication of the *Outline for Discussion*. In Step Two, the *Outline for Discussion* will be widely distributed for comment. A more detailed discussion of Step Two may be found in Section 8: Next Steps.

During Step One, the Postal Service held twelve meetings with representatives from employee, mailer, supplier and policy maker groups to ensure that the phases discussed in the previous section covered the range of issues necessary in a Comprehensive Transformation Plan. These meetings were beneficial in the development of this *Outline for Discussion*. There have also been ongoing discussions with the General Accounting Office. Sessions were held with the staff of the Senate Governmental Affairs Committee and its Subcommittee on International Security, Proliferation and Federal Services and with the staff of the House Committee on Government Reform. In addition, meetings were held with members and staff of the Postal Rate Commission and with representatives from postal unions, three management associations, members of the Main Street Coalition, and the Coalition to Preserve Universal Mail Service. Numerous discussions were also held with mailers and the associations that represent them. A meeting was held with one of the Postal Service's key partners and suppliers.

A number of key themes emerged from the meetings:

- Most participants noted the current critical financial situation facing the Postal Service. There was no general agreement on whether the current situation would follow the historical pattern and reverse when the economy recovered. Nor was there agreement on whether the current financial situation is the beginning of a downward trend stimulated by the technology revolution and economic downturn. Of those who felt it was the beginning of a downturn, there was no consensus on how to solve the problem. Suggestions ranged from “sun-setting” the Postal Service, to focusing on various approaches to achieving moderate legislative reform, to complete privatization into a stock company with public shares sold to the public.

- Increasing prices were a key concern of almost all parties. Customers who perceive that they have no feasible alternatives to the mailing system are particularly concerned with rising prices.
- While some seemed to feel that mail volume would rebound with an improving economy, most felt that the Internet and globalization have changed the future of hard copy delivery and that the Postal Service faces potential acute, long-term revenue problems.
- Stakeholders were evenly split on the extent to which the Postal Service should limit its focus to letters, flats, and parcels. There was no agreement on a definition of the Postal Service's core products.
- There was no agreement on whether the universal service obligation should be left as a general statement or redefined to narrow its boundaries.
- Stakeholders who felt most closely tied to postal products worried about the cost of being left in the system and having to cover major cost increases as others might leave.
- There was general support for management efforts to improve productivity and cut costs, but there was concern with future workforce costs and competition from other international and domestic companies.
- Finally, there was general concurrence with the basic approach for the development of the *Outline for Discussion*.

So far there is no clear consensus among stakeholders about the vision of the future postal service. In the case of the transformation phase that relates to fundamental structural reform, the stakeholders noted many issues that will require discussion with Congress: the definition of universal service; discomfort with competitive service offerings; concern with long-term, personnel-related costs; facilities utilization; and, the optimization of the postal network.

NEXT STEPS IN STAKEHOLDER INPUT

SECTION 8: NEXT STEPS IN STAKEHOLDER INPUT

The publication of this document marks the end of Step One of the stakeholder outreach effort. Step Two calls for the following actions to be taken to reach representatives in each of the five general stakeholder audiences: employees, mailers, consumers, suppliers and policy makers.

This *Outline for Discussion* will be published on the Postal Service's Strategic Direction web site at www.usps.com/strategicdirection. Organizations representing employees and mailers will be contacted and asked to comment using a special email address. Policy makers, the Postal Rate Commission, postal suppliers, individual mailers, national accounts, those who intervened in the last rate case, members of the Postal Service Supplier Quality Council, the Mailers' Technical Advisory Committee, the Mail Industry Task Force and the Marketing Advisory Board will also be contacted, directed to the web site, and asked to comment using the specially designated email address. Comments will be tracked, categorized, analyzed and relied on in the preparation of the Comprehensive Transformation Plan.

To reach as many stakeholders as possible, a special notice will be placed in the Federal Register directing interested parties to the Strategic Direction web site so that they may comment electronically on the transformation effort and this *Outline for Discussion*. Interested persons may write directly to the Postal Service during the public comment period that will last until November 1, 2001. All comments should be emailed to: transformation@email.usps.gov or mailed to Julie S. Moore, Executive Director, Office of Transformation, Strategic Planning, Room 4011, U.S. Postal Service Headquarters, 475 L'Enfant Plaza, SW, Washington, DC 20260-1520.

To obtain further input from consumers and businesses, focus groups will be conducted. A review of past consumer surveys on postal issues will be made to find relevant information. Through publication in internal communication channels, postal employees will be updated on the development of the Transformation Plan and asked for input. The opinions of postal executives will be solicited at the annual National Executive Conference October 22–24, 2001 and via a post-conference survey on the Strategic Direction web site. Employees identified as future Postal Service leaders will also be contacted.

Additional stakeholder meetings will be held during October and early November. Several meetings, including one with the Steering Committee of the Mailers' Technical Advisory Committee (MTAC) will be held at the fall National Postal Forum, a trade

convention held in Denver, CO in late October. In November, a briefing will be given to the general MTAC membership.

TRANSFORMATION OFFICE

The Postmaster General has made the Transformation project one of his highest priorities. The vice presidents and senior executives selected by the Postmaster General to undertake the preparation of the Transformation Plan will serve on a Steering Committee that will guide this effort and continue to coordinate stakeholder input and internal analysis of the transformation phases. Experts and specialists from throughout the agency will develop strategies and analyze the impact of proposed changes. As needed, specialists from other government agencies and from the private sector will also be contacted and asked to focus on and address postal transformation. Executives of the Postal Service will continue to meet regularly with policy makers to apprise them of the ongoing process and to receive their feedback prior to publication of the Transformation Plan at the end of the year.

CONCLUSION

SECTION 9: CONCLUSION

The Postmaster General has labeled the Transformation Plan a “living document.” This *Outline for Discussion* is the first step in what is expected to be an ongoing process of interaction and public policy debate. This process is intended to grant the policy makers the opportunity to make informed decisions about the future of the Postal Service.

To best serve the needs of the American people and the American economy in the 21st century, what should America’s postal system be like (or transform to) in the next decade? As the process proceeds, this core question, as well as the questions that follow, will need to be addressed.

- **Should that system provide “universal service” and what should that entail?**

Traditional concepts of universal service in the United States have included a number of characteristics including delivery scope and delivery standards, access to post offices, uniform pricing, product offerings and security services. Should all of these features continue to be a part of postal services? For example, should the Postal Service deliver to every neighborhood every day? Should delivery frequency be reduced for low mail volume neighborhoods? Should the scope of the retail service to nearly 40,000 outlets continue? Should alternative delivery methods be encouraged?

- **What should the “core” services of the future postal service be?**

Some observers such as the Comptroller General have challenged the Postal Service to define its core service more rigorously. What comparative advantages does the publicly owned Postal Service (versus other providers) bring to the mailing industry? What services should be left to the marketplace and to private competitors and what services should be provided by the national postal system?

- **How should the nation structure a future postal system to be as productive and efficient as possible and to ensure that consumers pay only what they wish to pay, for as much service as they can afford?**

The design of the operations of the future postal network has many variables. Often improvement in productivity and efficiency through cost cutting can come at a cost to improved service. Which values are most important? Should maintenance

nance of affordable pricing be more important than improving service? Or the reverse? What level of productivity and efficiency will guarantee that the cost of postal services is low but that service remains high? Should there be more rigorous automation standards as there are in other countries? What should the characteristics of the future postal operations network be?

- **Can the Postal Service continue to provide universal service under the current financial arrangements if volume slows or declines significantly? Are there other financing mechanisms needed?**

The critical threat to the current economic model is thought by many observers to be connected to volume decline. How should the Postal Service seek to finance its operations in the event that volume does decline? Should the future Postal Service seek support through the appropriations of tax revenues? Should universal service be narrowed? Are there other financing mechanisms that should be explored even without potential volume declines? Should the Postal Service be granted more freedom in financing investments?

- **What steps should be taken today to anticipate the human capital requirements of the future postal system in a manner that embodies core values of respect, dignity and diversity while providing incentives to encourage continuous service improvement?**

How should the balance be struck between individual values and improving the efficiency of the postal system? Is there a trade-off today? What investments should be made in attracting, training, managing, and providing incentives to people to build the future postal system? Should incentives be tied to performance throughout the postal system? Is the collective bargaining process, as it is structured today, going to serve the needs of the future Postal Service? Should salary caps be removed? Where should the priorities be?

- **Is it possible to design a government postal system in the United States that operates more commercially and still serves important social objectives including universal coverage?**

How might the Postal Service offer competitive products? If the private sector is offering similar services, should the publicly owned postal service enter markets where it would compete with the private providers? There are both advantages and disadvantages for the public agency in offering services in competitive markets. Is the playing field uneven in favor of the public or private sector service provider?

- **How would a privately owned postal entity or entities perform against public expectations for postal services? Are there other models that may do a better job for the American people?**

A number of key postal policy voices in recent years have called for the privatization of the Postal Service. Is this desirable? Would a corporatized postal service be able to be more productive? To provide better service? To grow the mailing busi-

ness for the postal industry? Or are there other models of fundamental structural reform that should be considered? Should the postal system be franchised out to private sector providers? Should fundamental structural reform retain the continuity of the end-to-end infrastructure that exists today?

As mentioned in the previous section, all comments should be sent by email to: transformation@email.usps.gov or mailed to Julie S. Moore, Executive Director, Office of Transformation, Strategic Planning, Room 4011, U.S. Postal Service Headquarters, 475 L'Enfant Plaza, SW, Washington, DC 20260-1520

Informal discussions with stakeholders and policy makers have reconfirmed that there is a lack of policy consensus about the answers to these questions and others. There may not be a need for all stakeholders to agree on every question. It is to be expected that there may need to be a process of public policy discussion before issues can be resolved and a widely accepted Comprehensive Transformation Plan can be crafted. The purpose of this *Outline for Discussion* is to facilitate this process.

APPENDIX A

POSTAL SERVICE BOARD OF GOVERNORS' LETTERS
MARCH 2, 2001
TO THE PRESIDENT OF THE UNITED STATES
AND CONGRESS



March 2, 2001

The President
The White House
Washington, DC 20500-0001

Dear Mr. President:

We understand and appreciate that your Administration has begun to deal with a number of important issues but wish to call to your attention a situation which, if not addressed shortly, will begin to have a significant and negative impact on the economy of the United States. We, the Governors of the United States Postal Service, nominated by various Presidents and confirmed by the United States Senate, urge that you devote your attention and resources necessary to implement a comprehensive review and overhaul of the postal laws of the United States. We have unanimously concluded that the present statutory scheme puts at serious risk our ability to provide consistent and satisfactory levels of universal service to the American people, generally recognized as delivery to every address every day, at uniform, affordable rates.

Nearly 31 years ago Congress passed, and President Nixon signed, the Postal Reorganization Act, which transformed the former Post Office Department into a modern and efficient postal system. An essential federal public service was to be provided on a business-like basis with no taxpayer subsidy. Over the course of the last quarter century, however, postal markets and technological innovation have evolved and fundamentally changed the assumptions on which the former legislation was based. The statutory framework simply does not provide practical and adaptable solutions in today's rapidly changing and truly global communications environment.

The Postal Reorganization Act obligates the Postal Service to provide universal service to America under regulatory and rate-setting schemes now hopelessly outdated. Prices for domestic services, which must be cost-based, require approximately 18 months to prepare, litigate, and implement. By contrast, our competitors are able to change prices immediately. Those competitors do not, however, share our obligation to serve all Americans every day, in all areas, including rural and inner city.

The Act established a system of collective bargaining followed by compulsory arbitration that mitigates against a negotiated settlement and which, moreover, has often placed some 80 percent of our total costs in the hands of a third-party arbitrator with neither understanding of nor responsibility for our role and mission.

We see alarming trends that seriously threaten the future of America's mail service. The conditions which provided steady growth in mail volumes and revenues and which enabled the infrastructure improvements necessary over the past 30 years are changing rapidly.

We have achieved record productivity and service levels over the last several years, but First-Class Mail volume growth is in decline. Costs, driven by our antiquated statutory scheme, are growing faster than revenues, and margins are shrinking. We are facing a Fiscal Year 2001 deficit likely to exceed \$2 billion and a financial crisis that cannot be averted by better management alone.

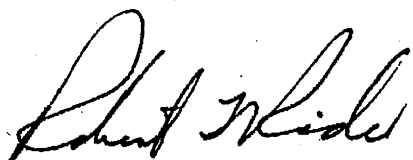
We have taken appropriate steps to address the situation. We have directed that nonessential activities be curtailed or eliminated. We have reduced the capital commitment budget by a billion dollars, to a level that challenges our ability to maintain our physical plant. We are taking steps to increase our prices. These actions will assist in the short-term. You have our assurance that we will take steps within our power to sustain the institution. Long-range solutions, however, require substantial changes to our regulatory framework.

The entire mailing community is focused on the need for postal change. The General Accounting Office has repeatedly sounded the alarm about the uncertain future of the U.S. Postal Service. The United States now lags far behind postal reform accomplishments in other advanced countries, which have restructured postal systems along highly commercial lines. Without change to our regulatory framework, universal service will be difficult to maintain. We foresee rapidly rising rates and reduced service if legislative reform is not enacted promptly.

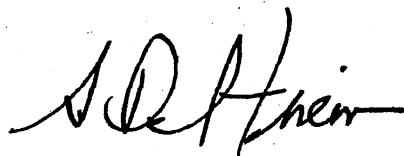
We urge your leadership for change. We pledge our full assistance in an immediate bipartisan effort to modernize the Nation's postal laws and regulations.

Thank you for your consideration of this appeal.

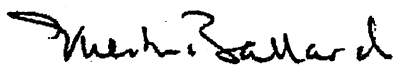
Sincerely,



Robert F. Rider
Chairman



S. David Fineman
Vice Chairman



Ernesta Ballard
Governor



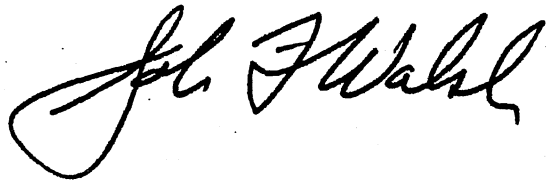
LeGree S. Daniels
Governor



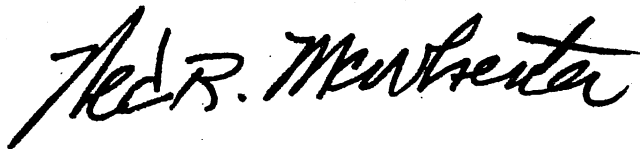
Alan C. Kessler
Governor



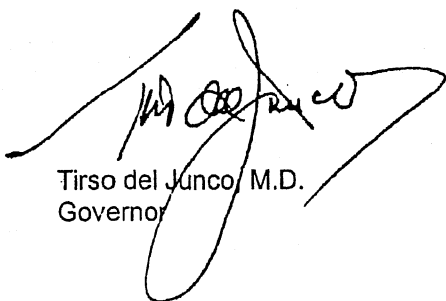
Einar V. Dyhrkopp
Governor



John F. Walsh
Governor



Ned R. McWherter
Governor



Tirso del Junco, M.D.
Governor



March 2, 2001

Honorable Fred Thompson
Chairman
Committee on Governmental Affairs
United States Senate
Washington, DC 20510-6250

Dear Mr. Chairman:

We understand and appreciate that you have begun to deal with a number of important issues but wish to call to your attention a situation which, if not addressed shortly, will begin to have a significant and negative impact on the economy of the United States. We, the Governors of the United States Postal Service, nominated by various Presidents and confirmed by the United States Senate, urge that you devote your attention and resources necessary to implement a comprehensive review and overhaul of the postal laws of the United States. We have unanimously concluded that the present statutory scheme puts at serious risk our ability to provide consistent and satisfactory levels of universal service to the American people, generally recognized as delivery to every address every day, at uniform, affordable rates.

Nearly 31 years ago Congress passed, and President Nixon signed, the Postal Reorganization Act, which transformed the former Post Office Department into a modern and efficient postal system. An essential federal public service was to be provided on a business-like basis with no taxpayer subsidy. Over the course of the last quarter century, however, postal markets and technological innovation have evolved and fundamentally changed the assumptions on which the former legislation was based. The statutory framework simply does not provide practical and adaptable solutions in today's rapidly changing and truly global communications environment.

The Postal Reorganization Act obligates the Postal Service to provide universal service to America under regulatory and rate-setting schemes now hopelessly outdated. Prices for domestic services, which must be cost-based, require approximately 18 months to prepare, litigate, and implement. By contrast, our competitors are able to change prices immediately. Those competitors do not, however, share our obligation to serve all Americans every day, in all areas, including rural and inner city.

The Act established a system of collective bargaining followed by compulsory arbitration that mitigates against a negotiated settlement and which, moreover, has often placed some 80 percent of our total costs in the hands of a third-party arbitrator with neither understanding of nor responsibility for our role and mission.

We see alarming trends that seriously threaten the future of America's mail service. The conditions which provided steady growth in mail volumes and revenues and which enabled the infrastructure improvements necessary over the past 30 years are changing rapidly.

We have achieved record productivity and service levels over the last several years, but First-Class Mail volume growth is in decline. Costs, driven by our antiquated statutory scheme, are growing faster than revenues, and margins are shrinking. We are facing a Fiscal Year 2001 deficit likely to exceed \$2 billion and a financial crisis that cannot be averted by better management alone.

We have taken appropriate steps to address the situation. We have directed that nonessential activities be curtailed or eliminated. We have reduced the capital commitment budget by a billion dollars, to a level that challenges our ability to maintain our physical plant. We are taking steps to increase our prices. These actions will assist in the short-term. You have our assurance that we will take steps within our power to sustain the institution. Long-range solutions, however, require substantial changes to our regulatory framework.

The entire mailing community is focused on the need for postal change. The General Accounting Office has repeatedly sounded the alarm about the uncertain future of the U.S. Postal Service. The United States now lags far behind postal reform accomplishments in other advanced countries, which have restructured postal systems along highly commercial lines. Without change to our regulatory framework, universal service will be difficult to maintain. We foresee rapidly rising rates and reduced service if legislative reform is not enacted promptly.

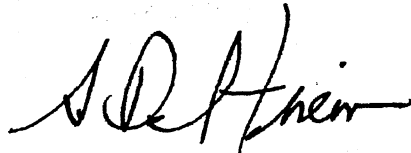
We urge your leadership for change. We pledge our full assistance in an immediate bipartisan effort to modernize the Nation's postal laws and regulations.

Thank you for your consideration of this appeal.

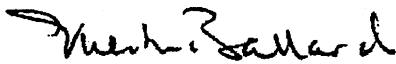
Sincerely,



Robert F. Rider
Chairman



S. David Fineman
Vice Chairman



Ernesta Ballard
Governor



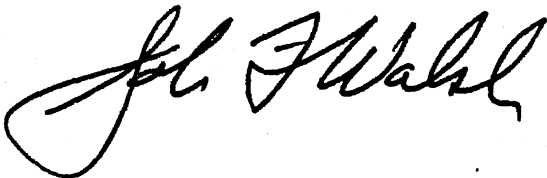
LeGree S. Daniels
Governor



Alan C. Kessler
Governor



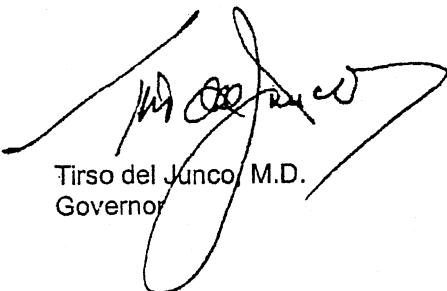
Einar V. Dyhrkopp
Governor



John F. Walsh
Governor



Ned R. McWherter
Governor



Tirso del Junco, M.D.
Governor



March 2, 2001

Honorable Dan Burton
Chairman
Committee on Government Reform
Washington, DC 20515-6143

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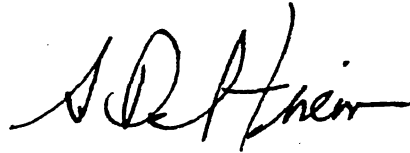
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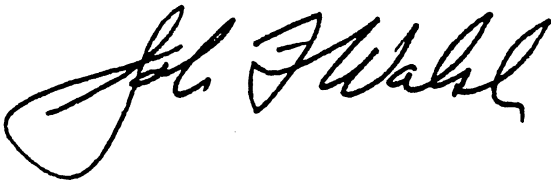
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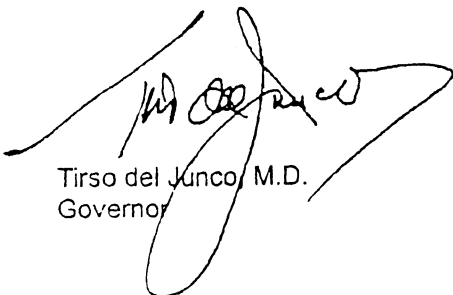
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Governor



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Ned R. McWherter
Governor



Tirso del Junco, M.D.
Governor

**TESTIMONY OF COMPTROLLER GENERAL
DAVID WALKER, APRIL 4, 2001
BEFORE THE HOUSE OF REPRESENTATIVES
GOVERNMENT REFORM COMMITTEE**



Testimony

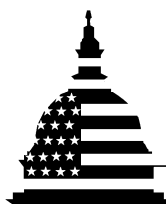
Before the Committee on Government Reform
House of Representatives

For Release on Delivery
At 10:00 a.m. EDT
Wednesday
April 4, 2001

U.S. POSTAL SERVICE

Transformation Challenges Present Significant Risks

Statement by David M. Walker
Comptroller General of the United States



G A O

Accountability * Integrity * Reliability

Mr. Chairman and Members of the Committee:

We are pleased to be here today to participate in the Committee's hearing on the U.S. Postal Service (the Service). Overall, the Service faces major challenges that collectively call for a structural transformation if it is to remain viable in the 21st century. In my testimony, I will briefly review the Service's growing financial, operational, and human capital challenges in an increasingly competitive environment; discuss the Service's financial outlook; and make suggestions on what needs to be done to address the challenges facing the Service.

The Service's projected financial losses have increased significantly during the past 4 months. Over the past 2 years we have raised concerns about a range of financial, operational, and human capital challenges that threaten the Postal Service's ability to continue to provide affordable, high-quality universal postal service on a self-financing basis. Moreover, the Service's financial outlook has worsened more quickly than expected, and it is not clear how the Service will address its mounting financial difficulties and other challenges. These challenges include:

- The Service's net income has declined over the past 5 years, and the Service currently projects a fiscal year 2001 deficit in the \$2 billion to \$3 billion range, up from a projected loss of \$480 million just 4 months ago. About \$1.8 billion in projected losses are based on results for the first 2 quarters and revised estimates for losses in the last 2 quarters of fiscal year 2001. Based upon its judgment, the Service is also projecting that the slowing economy will further lower net income by \$300 million to \$1.3 billion. Further, in fiscal year 2002, the Service estimates that its deficit will be in the \$2.5 billion to \$3.5 billion range, assuming no further increases to postal rates.
- The Service has experienced a net increase in outstanding debt at the end of each fiscal year since 1997, and its total outstanding debt reached \$9.3 billion at the end of fiscal year 2000. Service officials expect the Service could reach its \$15 billion statutory debt limit by the end of fiscal year 2002, assuming no additional increases in postal rates. At the same time, the Service has curtailed capital investment to conserve cash in fiscal year 2001. In addition, the Service has no plan to reduce its debt. Depending on future events, the Service may face a cash shortage in fiscal years 2002 and/or 2003.
- The Service faces increasing competition from both domestic and foreign-based entities. It also expects electronic diversion—such as greater use of the Internet—to cause substantial declines in First-Class Mail volume in the next decade and thus place the Service under “extreme financial pressure.”
- Although the Service has taken steps and plans to cut costs by \$2.5 billion by 2003, increase productivity, and improve human capital programs, it has historically had great difficulty achieving desired results in these areas. For example, numerous reports, including some by us and the Postal Service Office of Inspector General (OIG), have noted inefficiencies in the postal system and difficulties the Service has had in realizing opportunities for savings.
- The Service has also had periodic conflicts with some of its key stakeholders including postal unions and the Postal Rate Commission. We have noted longstanding labor-management relations problems that have hindered improvement efforts, including three labor agreements that expired in November 2000. In addition, the Postal Service and the Postal Rate Commission have had longstanding disagreements concerning pricing decisions.

- The Service is subject to several statutory and other restrictions that serve to limit its transformational efforts (e.g., binding arbitration requirement, a cost-based rate-setting process, and facility closure restrictions).
- Finally, two key leadership positions need to be filled relating to postal operations and rate setting (Postmaster General and Chairman of the Postal Rate Commission.)

We believe that the Service's deteriorating financial situation calls for prompt, aggressive action, particularly in the areas of cutting costs and improving productivity. Accordingly, we are adding the Postal Service's transformational efforts and long-term outlook to our High-Risk List, effective immediately, so that we and others can focus on its financial, operational, and human capital challenges before the situation escalates into a crisis where the options for action may be more limited. In this regard, we believe the following actions need to be taken:

- The Service should develop a comprehensive plan, in conjunction with Congress and other stakeholders, such as the postal unions and management associations, customers, and the Postal Rate Commission, that would identify the actions needed to address the Service's financial, operational, and human capital challenges and establish a timeframe and specify key milestones for achieving positive results.
- The Service should provide summary financial reports to Congress and the public on a quarterly basis. These reports should present sufficiently detailed information for stakeholders to understand the Service's current and projected financial condition, how its outlook may have changed since the previous quarter, and its progress toward achieving the desired results specified in its comprehensive plan.
- GAO will work with Congress and the Service to help identify improvement options and will continue to analyze and report to Congress on the Service's ongoing financial condition. In consultation with other postal stakeholders including the Postal Service Office of Inspector General, postal unions and management associations, the Postal Rate Commission, and customers, we will review the Service's financial results and future outlook, progress on cost-cutting and productivity efforts, other countries' experiences, and options for addressing the Service's short-term and long-term challenges.

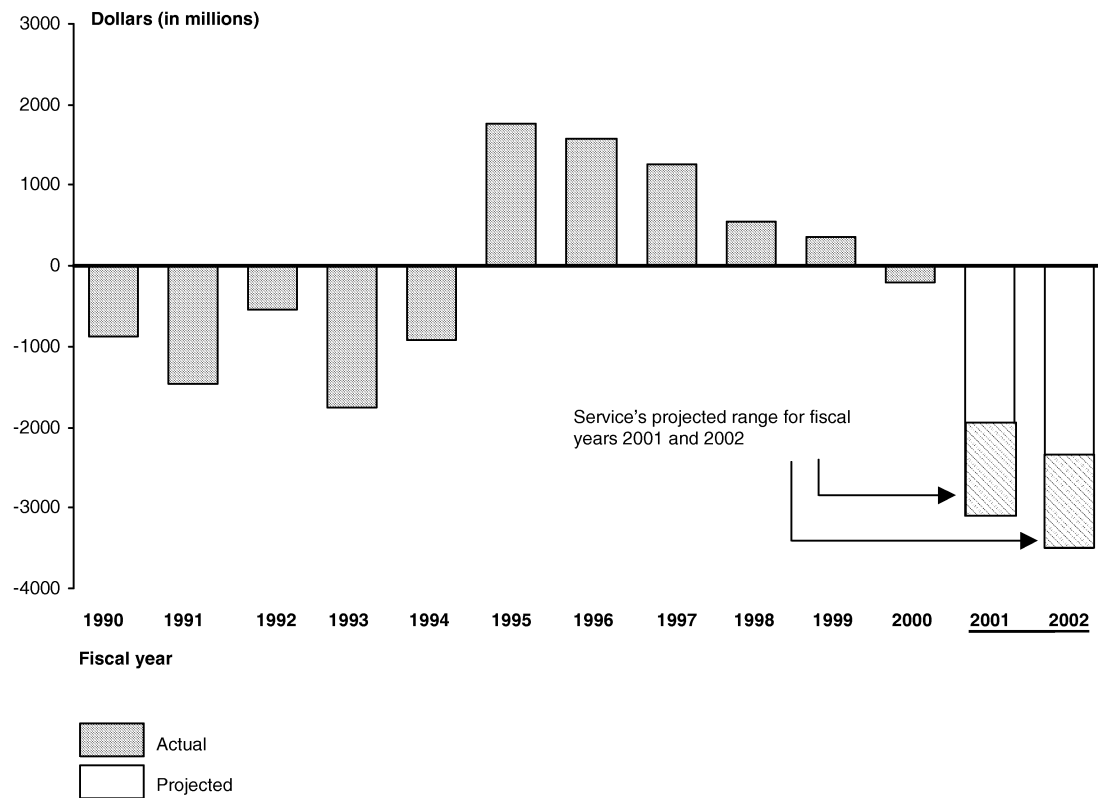
Historical Perspective on the Service's Financial Outlook

The \$2 billion to \$3 billion deficits estimated by the Service would be unprecedented, although the Service did experience financial difficulties in the early 1990s. The Service's financial position in the early 1990s was adversely affected by the 1990-1991 recession. Also, in 1990, legislation made the Service responsible for funding all health benefits and COLAs for its retirees since July 1, 1971. The Service reported that its financial turnaround in the mid-1990s was aided by rising mail volume, a rate increase that averaged approximately 10 percent in 1995, and a "moderate" increase in expenses. In addition, in the late 1990s, the Service improved the timely delivery of First-Class Mail.

As figure 1 shows, the Service's financial turnaround occurred in fiscal year 1995. The Service raised the price of the First-Class stamp from 29 cents to 32 cents on January 1, 1995. The Service's net income has declined in every year since fiscal year 1995 despite general rate

increases that raised the First-Class stamp price to 33 cents on January 10, 1999, and to 34 cents on January 7, 2001.

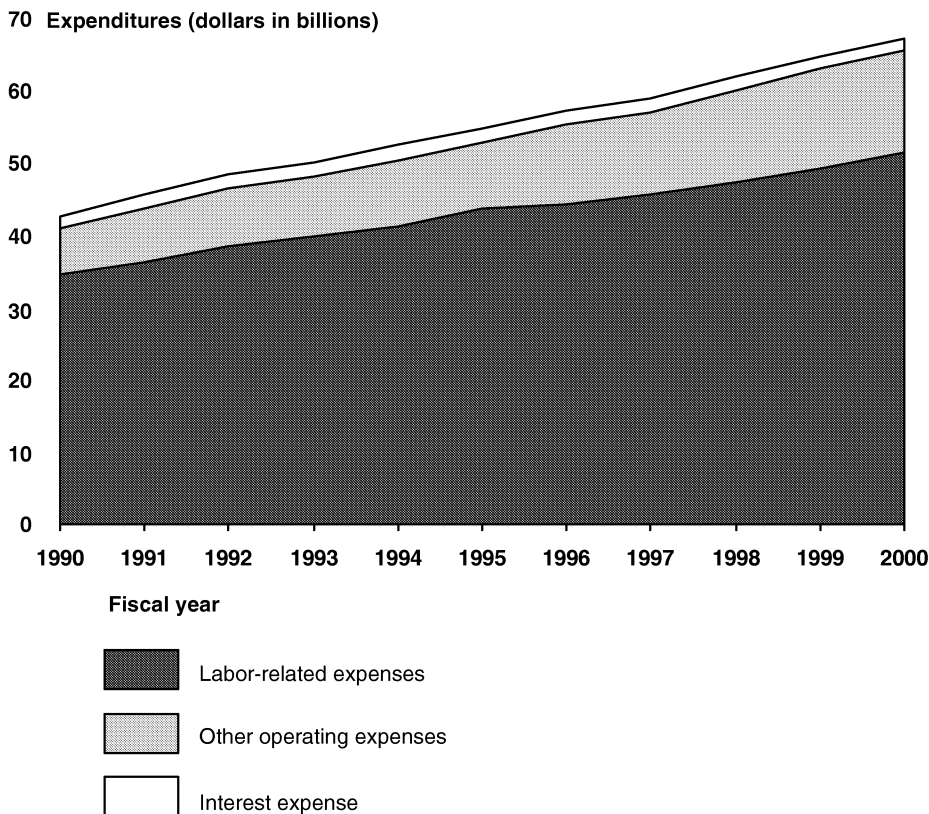
Figure 1: Postal Service Net Income From Fiscal Year 1990 Through 2002



Source: U.S. Postal Service.

One reason for the declining net income has been continued growth in postal expenses (see fig. 2). The Service's delivery network continues to grow at a rate close to 2 million new household and business deliveries each year. Labor-related expenses continue to account for more than three-quarters of the Service's total operating expenses, despite multibillion-dollar expenditures for automation. Other operating expenses have also grown.

Figure 2: Trends in Postal Service Expenses From Fiscal Year 1990 Through 2000



Source: U.S. Postal Service.

The Service Faces Growing Challenges

The Service faces growing challenges in an increasingly competitive environment as it seeks to fulfill its mission: bind the nation together through the correspondence of the people; provide access in all communities; offer prompt, reliable, and efficient postal services at uniform prices; and be self-supporting and break even financially over time. In October 1999, we testified that the Service might be nearing the end of an era and confronting increasing challenges from competition, notably from private delivery companies and electronic communication alternatives such as the Internet.¹ The Service told us that it expected First-Class Mail volume to decline substantially in the next decade, assuming that the diversion of mail to electronic communications alternatives would accelerate in a new and vastly different environment in which the Service would be required to operate.

¹ *U.S. Postal Service: Challenges to Sustaining Performance Improvements Remain Formidable on the Brink of the 21st Century* (GAO/T-GGD-00-2, Oct. 21, 1999).

In September 2000, we testified that the Service continued to face an uncertain future in an increasingly competitive environment.² We reported that the Service believed that growth in its core business had already been negatively affected by the rapid growth of the Internet, electronic communications, and electronic commerce. We noted that a key oversight issue for the Service, Congress, and the American people is whether the Service is heading for financial shortfalls that could, in the long run, hinder its ability to carry out its mission of providing affordable, universal services that bind the nation together. We also reported that the Service had experienced increasing difficulties in meeting its goal of \$100 million in net income for fiscal year 2000. Based on its annual financial statements, the Service experienced a net loss of \$199 million for fiscal year 2000, its first deficit since fiscal year 1994.

In January 2001, we reported to Congress on the potential consequences if the Service incurred a series of large deficits. These could include increases in postal rates, declines in service quality, consolidation or closure of some facilities, or reconsideration of postal operations or even the scope of postal services.³ We also noted that fundamental issues concerning the Postal Service's role and authority have been raised in Congress, and various stakeholders have called for changing its legal and regulatory framework. We concluded that to be successful, the Service would need to address formidable performance and accountability challenges in five key areas, which can be posed as the following questions:

1. Can the Postal Service remain self-supporting while providing affordable, high-quality universal service?
2. Can the Service become more efficient by controlling its costs and improving productivity?
3. How will the Service address critical human capital issues, such as maintaining continuity and service in the face of the impending retirement of many postal employees, rapidly rising retirement and other personnel-related costs, and persistent labor-management problems?
4. Does the Service have reliable performance and cost information to effectively manage postal operations, identify inefficiencies, and track progress toward realizing anticipated cost savings?
5. What changes may be needed in the current legal and regulatory framework governing the Postal Service's role and mission so that it can remain self-supporting and provide affordable universal service in an increasingly competitive environment?

In the balance of my testimony today, I will focus on the first three questions. First, I will discuss the Service's short-term financial outlook and assess the Service's increasingly dire financial projections for this fiscal year. Second, I will discuss the Service's financial trends and issues relating to its cash and debt position. Third, I will focus on selected key long-term challenges, including human capital challenges, and conclude with some specific suggestions for action.

² *U.S. Postal Service: Sustained Attention to Challenges Remains Critical* (GAO/T-GGD-00-206, Sept. 19, 2000).

³ *Major Management Challenges and Program Risks: U.S. Postal Service* (GAO-01-262, Jan. 2001).

The Service's Short-term Financial Outlook Has Deteriorated

The Service is projecting significant losses over the next 2 years, although the full extent of the losses is uncertain. The Service currently estimates that its fiscal year 2001 deficit will range from roughly \$2 billion to \$3 billion—a sum that far exceeds the \$480 million deficit built into the Service's budget that was approved last November. About \$1.8 billion of this projected deficit is based on reported losses in the first 2 quarters and revised estimates for losses in the last 2 quarters. Depending on the economic situation for the rest of fiscal year 2001, the Service believes that losses could be much higher. Further, in fiscal year 2002, the Service estimates that its deficit will be in the \$2.5 billion to \$3.5 billion range, assuming no further increases to postal rates.

An important caveat: Our current assessment of the Service's financial outlook for this fiscal year is based on a preliminary review of the financial data and projections that the Service recently provided to us and on interviews with Service officials, including the Chief Financial Officer. The Service's financial situation is complex, and we are still assessing the validity of key data and assumptions that support the Service's financial projections. In addition, the Service is in the process of updating some of its key projections, such as projections of its revenues for the second half of this fiscal year. We will continue to review the Service's financial condition and will report again to Congress on this matter.

Factors Leading to the Service's Expected Deficit in Fiscal Year 2001

To understand the factors affecting the Service's financial outlook for this fiscal year, I will discuss where the Service stands today with results from the first 2 quarters and what it expects to happen during the last 2 quarters of the year. I will also discuss how the Service's net income projections have changed since the beginning of the fiscal year according to a series of adjustments the Service has made to its projected revenue and expenses. (See fig. 3.) Finally, I will discuss other factors that have not been included in the Service's projections but could affect the Service's financial results for this year, such as the Service's ability to achieve budgeted savings and revenues from new initiatives.

Figure 3: Changes in the Postal Service's Financial Outlook for Fiscal Year 2001

	Budgeted	Current
Reported Net Income: Quarters 1 and 2	\$200 M	-\$260 M
Originally Budgeted Net Income: Quarters 3 and 4	-\$680 M	-\$680 M
Expense Adjustments to Net Income: Quarters 3 and 4		-\$320 M
Revenue Adjustments to Net Income: Quarters 3 and 4		-\$500 M
<i>Subtotal</i>		<u>-\$1.8 B</u>
Other Revenue Adjustments to Net Income: Soft Economy-Quarters 3 and 4		-\$300 M to -\$1.3 B
Net Income	-\$480 M	-\$2.1 to -3.1B
FY 2001 Revised Deficit \$2.1 to \$3.1B		

Legend: Dollars in millions (M), billions (B).

Source: GAO presentation based on U.S. Postal Service estimates, which are subject to change.

The Service's financial outlook for fiscal year 2001 can be divided into the following categories: (1) \$260 million in reported losses for the first half of the fiscal year, (2) \$680 million in budgeted losses for the balance of the fiscal year, (3) \$320 million in expenses higher than estimated for the last 2 quarters, (4) \$500 million in revenues lower than budgeted for the last 2 quarters due to lower-than-requested increases in postal rates, and (5) \$300 million to \$1.3 billion in revenues lower than budgeted for the last 2 quarters due to the slowing economy and its impact on mail volume and revenues. The uncertainty of the impact of the economy for the remainder of the fiscal year is the largest single factor in the Service's projections that may impact its expected losses for fiscal year 2001, and the estimated range is based on the Service's judgment.

Reported Losses for the First Half of Fiscal Year 2001

As figure 3 shows, the Service reported that its loss for the first 2 quarters of this fiscal year was about \$260 million. This reported amount is not audited and is subject to change. It is important to note that historically, the Service's financial performance tends to be stronger in the first part of the fiscal year, which includes the busy holiday mailing season. The \$260 million loss during its typically strongest earnings period is a further sign of the Service's financial difficulties. The Service had budgeted for \$200 million in net income for the first half of the fiscal year; so, thus far it is running \$460 million behind its budget targets. Further, the Service achieved nearly \$1 billion in net income in the first half of last fiscal year – a year in which it ended with a \$199 million loss.

Additional Losses Built into the Service's Fiscal Year 2001 Budget

In its fiscal year 2001 budget, the Service estimated that it would incur a \$680 million deficit for the last 2 quarters of the fiscal year. When this amount is added to the \$260 million deficit incurred in the first half of the fiscal year, the Service would lose nearly \$1 billion in fiscal year 2001. This estimated loss does not include a number of developments that could have a negative impact on the Service's net income this year, which are detailed below.

Additional Unbudgeted Expenses

The Service currently projects that its expenses for the remaining 2 quarters of this fiscal year will be \$320 million greater than budgeted, and gave us supporting information for these estimated expenses. For example, the Service told us that it is experiencing greater transportation expenses because of increases in fuel costs and cost passthroughs from its transportation contractors, among other factors. International mail expenses are also expected to be higher than budgeted because of recent increases in "terminal dues" paid to foreign postal administrations to deliver outbound U.S. international mail. Workers' compensation expenses are also expected to be greater than budgeted and to reach \$1.1 billion for the full fiscal year – a significant increase from last year and the late 1990s.

Additional Revenue Shortfalls Relating to Postal Rates and New Revenue Initiatives

The Service projected revenues for the last 2 quarters of fiscal year 2001 to be \$500 million below its budgeted targets due to the gap between the requested rates and those implemented in January. The Service's budget for fiscal year 2001 assumed that the Service would receive the full increase in postal rates that it had requested in the 2000 rate case. However, the Postal Rate Commission recommended a rate increase that averaged 4.6 percent—more than 2 percent lower than the requested amount. These rates were put into effect this January and included a 1-cent increase in the price of a First-Class stamp to 34 cents.

Additional Revenue Shortfalls Attributed to the Slowing Economy

The Service further lowered its revenue projections for the second half of fiscal year 2001 by \$300 million to \$1.3 billion on the basis of the Service's judgment of a "continued soft economy" and the resulting negative impact on mail volume and revenues. The \$1 billion range reflects the Service's uncertainty associated with the length and severity of the economic slowdown and its impact on postal revenues. The Service told us it is in the process of updating its mail volume and revenue forecasts for the rest of fiscal year 2001.

Other Factors May Add to the Service's Deficit for Fiscal Year 2001

The Service's expenses could be higher than it currently estimates because it is not on track to achieve some cost-reduction targets. For example:

- The Service planned to decrease its work hours by 1.5 percent from last year's level—which would translate into a reduction of 13,200 work years for the full fiscal year. Although the

Service reported that work hours declined in the first 2 quarters of fiscal year 2001 compared to the first 2 quarters of last fiscal year, the decline was only about half of its target.

- The Service planned for decreasing overtime work hours by about 6 percent in the first 2 quarters from last year's level. However, the Service reported that overtime increased in the first 2 quarters and is running about 13 percent higher than the budgeted targets so far this fiscal year, although some recent progress has been made in reducing overtime.
- The Service's planned reductions in total work hours assume efficiency gains in most aspects of its operations. An estimated 60 percent of the savings is related to greater efficiencies in handling flat mail, such as catalogs and periodicals, and from machines sorting mail for carriers in the sequence it is to be delivered. However, these budgeted savings will be difficult for the Service to fully realize. First, Service officials told us that it takes three to six employees to prepare flat mail to be loaded into its new sorting machines, thus diminishing cost efficiency, although the Service noted it is working with mailers to address this issue. Second, the Service has reported that carrier costs exceeded budgeted targets by \$130 million for the first 2 quarters of this fiscal year. Carrier costs were reportedly affected by greater-than-expected volumes of low-margin advertising mail; the worst winter weather in a decade; and difficulty in finding and retaining replacements for rural carriers, which resulted in higher overtime costs.
- The Service expected efficiency gains to result in reductions through attrition. The number of career employees has been declining, while at the same time there have been increases in the number of non-career workers. The Service has said that it might be necessary to offer voluntary early retirements in some cases, or possibly move into isolated reductions-in-force.

Strategies to Improve Net Income

To improve its net income situation in fiscal year 2001 and 2002, the Service will need to increase revenues and/or cut costs and improve productivity. Adding to this challenge will be maintaining the quality of service. The Service is currently making efforts in these areas. The following is a brief discussion of the Service's short-term potential for making further progress.

- Cut operating costs and improve productivity: We have repeatedly emphasized that this should be a priority area for the Service; however, progress historically has been difficult to achieve. Service officials have emphasized some key barriers, such as restrictions on closing unprofitable post offices or limited flexibility in changing workforce deployment, have contributed to the difficulty of making progress in this area. The Service's overall productivity has increased only about 11 percent in the past 3 decades despite vast changes in automation and information technology. The Service has recognized that it needs to make progress in cutting its costs and improving productivity and is currently taking steps to do so. Last week, the Deputy Postmaster General announced that the Service is committed to cutting costs by \$2.5 billion by 2003. He said that over the next 5 years, the Service plans to cut 75,000 work years, reduce administrative costs by 25 percent, and cut transportation costs by 10 percent. The Service has not yet specified, however, how these cuts would be achieved. The Service improved productivity in fiscal year 2000 by 2.5 percent and its budget for fiscal year 2001 calls for a 0.7 percent productivity increase. Service officials are also planning for a 2-percent increase in fiscal year 2002, and a 1-percent increase the year

after that—a set of positive productivity increases over 4 consecutive years that they noted would be unprecedented.

- Generate more revenues from new products and services: We believe that it will be difficult for the Service to generate significant revenues from new products and services in the next few years. Historically, as our 1998 report showed, the Service’s new product and service initiatives underway during the mid-1990s generally were not profitable.⁴ Further, the Service’s 5-Year Strategic Plan for fiscal years 2001 through 2005, dated September 30, 2000, stated that no significant new revenue is forecast from new products and services during the next 5 years. The Service has not achieved its revenue targets from its new initiatives for the first half of this fiscal year. Recently, the Service has made downward revisions in its projected revenues from its new revenue initiatives for the second half of fiscal year 2001.
- Raise postal rates: To the extent that operating costs are not contained or reduced, or revenues are not generated from new products and services, the Service will likely need to raise rates to maintain service and to meet its break-even mandate, at least in the short term. The Deputy Postmaster General recently said that the Service may not be able to avoid raising postal rates; but he added that at present, the Service does not know the timing, size, or details of the next rate case. Some stakeholders have expressed strong concern that the Service could request a rate increase of as much as 10 to 15 percent in the near future. However, the Service has also said that “This [option] would worsen the competitive position of the Postal Service and cause substantial disruption to key customer segments with little or no minimal direct substitutes for postal services, such as the publishing industry.” In the long run, raising rates may drive postal customers to increase their use of other alternatives, thereby affecting mail volumes and revenues.

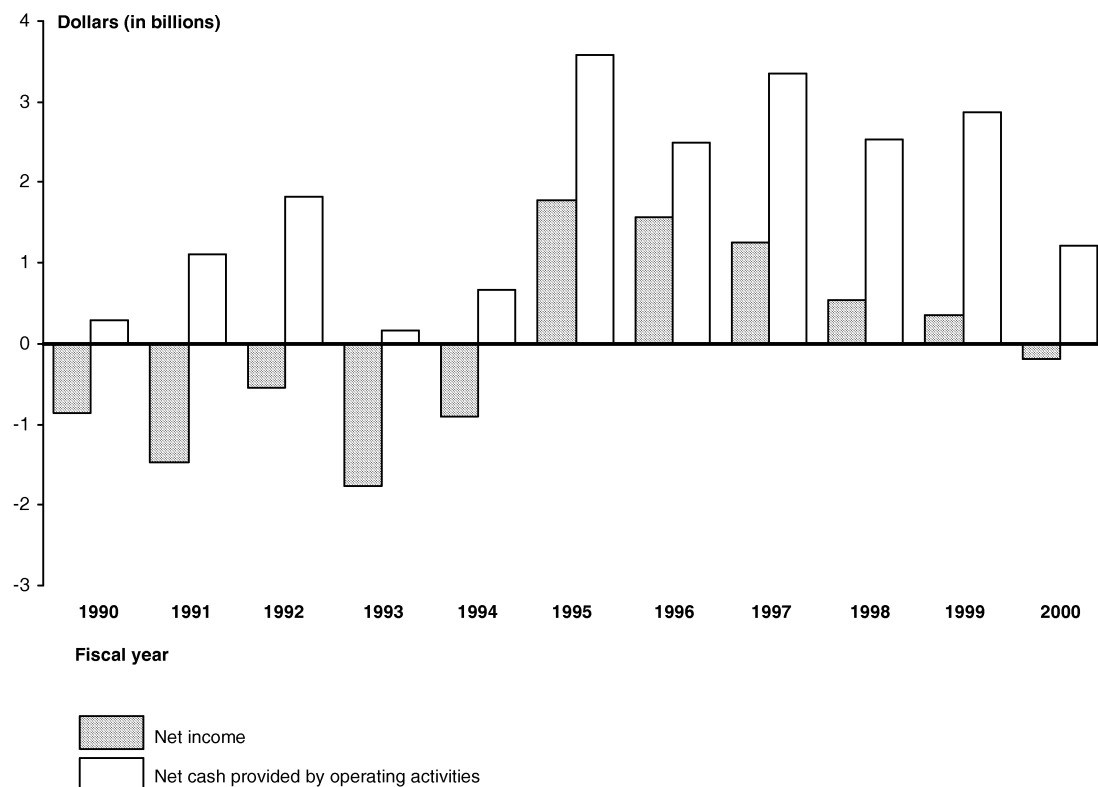
The Service Has Growing Cash Flow and Debt Challenges

The amount that the Service borrows on an annual basis is largely determined by the difference between its cash flows from operations and the amount it spends on capital investments. As shown in figure 4, the Service’s cash flows from operations are typically significantly greater than its net income. The primary reason for the difference is because net income is calculated on the accrual basis of accounting⁵ and includes accrued expenses, such as depreciation expense, that do not use cash.

⁴ *U.S. Postal Service: Development and Inventory of New Products (GAO/GGD-99-15, Nov. 24, 1998).*

⁵ Under the accrual basis of accounting, revenues are recorded when earned and expenses are recorded when incurred, even if these activities are not concurrent with the related receipt or outlay of cash.

Figure 4: Postal Service Net Income and Cash Flows From Operations

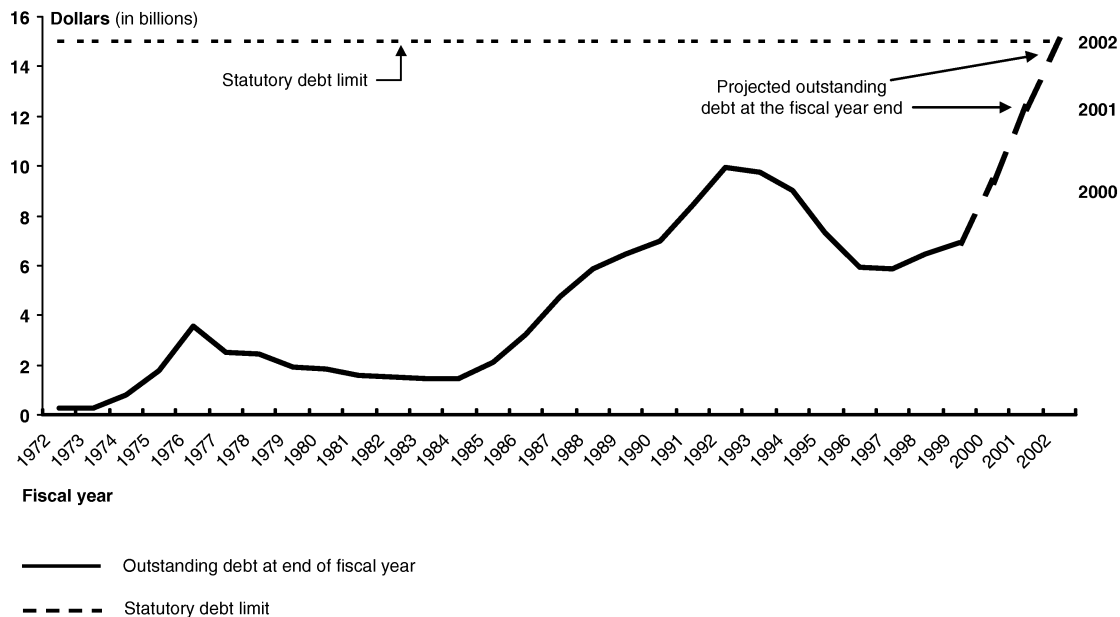


Source: U.S. Postal Service.

Beginning in 1998, the Service's cash outlays for capital expenditures exceeded its cash flows from operations. The Service's debt increased from \$5.9 billion at the end of fiscal year 1997 to \$9.3 billion at September 30, 2000. The Service anticipates that its projected operating deficit for the full fiscal year 2001 will weaken its cash flows from operations. By way of background, the Service has a statutory borrowing limit of \$15 billion and also has an annual limit of increasing its outstanding obligations by \$3 billion (that includes a \$2 billion limit for capital improvements and a \$1 billion limit to defray operating expenses).

Service officials told us that assuming the Service's financial outlook is on target and there are no further changes in postal rates in fiscal years 2001 or 2002, the Service may reach its \$15 billion statutory borrowing limit by September 30, 2002 (see fig. 5). Under this scenario, the Service would have no additional borrowing authority at the beginning of fiscal year 2003. Once the Service reaches its statutory borrowing limit, it can pay its bills only through its cash on hand plus additional cash generated from operations until outstanding debt declines. The Service typically generates a cash surplus in the first part of the fiscal year. However, depending on the Service's income and cash from operations, the Service may face a cash shortage in fiscal years 2002 and/or 2003.

Figure 5: Trends in Postal Service Debt



Source: U.S. Postal Service

To avoid a cash shortage during fiscal year 2001, the Service has placed a freeze on capital commitments that will affect more than 800 facility projects. Last year the Service had planned capital commitments of \$3.6 billion for fiscal year 2001, but Service officials recently announced reductions in this area and told us they now anticipate a reduction to \$2 billion in capital commitments this fiscal year. Preliminary budget plans for fiscal year 2002 would reduce capital investment from \$3.7 billion to \$2.4 billion. However, reducing needed capital investments serves only to defer capital improvements and associated efficiency gains.

Major Long-Term Performance Challenges Facing the Service

As difficult as the Service's short-term financial outlook may be, we are also concerned about its long-term prospects, given the trends toward increasing competition and its implications for postal revenues, coupled with continued upward pressure on postal costs, and human capital challenges. Therefore, unless the Service makes much more rapid progress in cutting costs and improving productivity, it will face increasing difficulty maintaining its position as a self-supporting provider of universal postal service at reasonable rates. The Postal Service and postal stakeholders have been debating for years whether major changes are needed in the legal and regulatory framework governing the Postal Service, but reaching consensus among the diverse stakeholders has been difficult to achieve.

To address the Service's long-term outlook, a fundamental reassessment of the Service's financial options and operating plans is in order. Better information may also be needed about recent changes in the dynamic postal and delivery sector, as well as on the short and long-term effects of postal rate changes on mail volumes, revenues, and costs. Further, an assessment is needed of the full range of actions that the Service can take under current law and identifying

areas where actions are needed. In making such a reassessment, which should also include identifying areas where statutory changes may be needed, the Service should consult with its stakeholders including unions and management associations, customers, and the Postal Rate Commission.

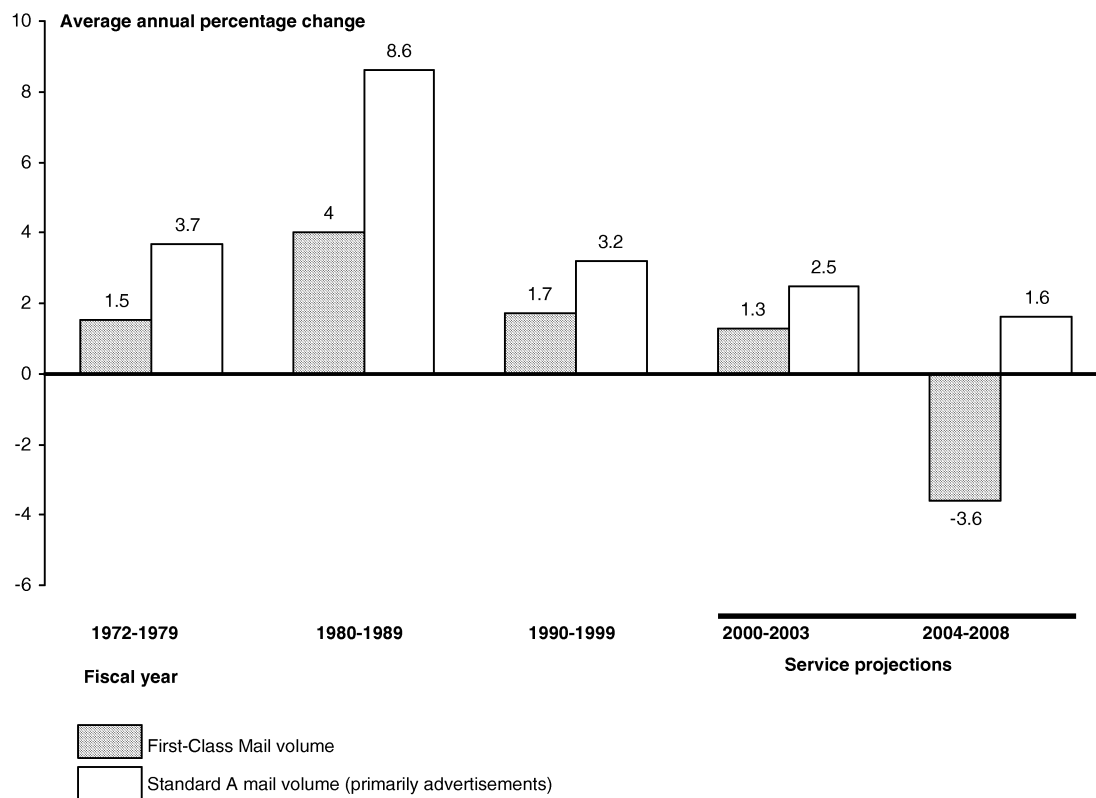
The Service's Viability to Fulfill Its Historic Mission

The Service faces greater competition and expects electronic diversion to cause substantial declines in First-Class Mail volume in the next decade which, according to the Service's most recent 5-year Strategic Plan, would place the Service under "extreme financial pressure." In this event, the Service, like many of its foreign counterparts, would likely face unprecedented challenges to its primary mission of providing universal postal service at reasonable rates while remaining self-supporting from postal revenues. The growing challenges are as follows:

- The Service would face the challenge of responding to any volume declines or changes in the mail mix by attempting to reduce mail processing, personnel, and other costs that have traditionally been considered to vary with changes in mail volume. Labor-related expenses continue to account for more than three-quarters of total postal service operating expenses and have reportedly been difficult to cut quickly in response to less-than-expected mail volumes and revenues. This fiscal year, the Service reported it has experienced continuing difficulty cutting costs when expected mail volumes and revenues did not materialize.
- If First-Class Mail volume declines and the revenue loss is not offset in other areas, rates would need to rise for any mail categories that take on a larger burden of supporting postal institutional costs. The Service maintains a delivery and retail network that includes more than 235,000 city and rural delivery routes; more than 38,000 post offices, stations, and branches; and more than 350 major mail processing and distribution facilities.
- Even if First-Class Mail volumes do not decline, Service officials expect that cost reductions may not be sufficient to keep future rate increases below the rate of inflation.
- Adding to rate pressure, postal infrastructure costs continue to grow. The Service has been adding many new delivery points to new households and businesses—a projected 1.8 million in fiscal year 2001.

Competition is already increasing from private delivery companies, foreign postal administrations accepting outbound international mail from within the United States; and electronic communications alternatives, such as the Internet. As an example of trends that have already affected the Service's mail volumes, federal agencies are mandated to move as quickly as possible to reduce paperwork and to adopt electronic billing and payment. Two-thirds of the 880 million Social Security checks, tax refunds, and other payments that were sent by the Department of the Treasury in fiscal year 1999 were sent electronically. Further, the banking industry's mail volume was almost 18 percent lower in 1999 than it was in 1996. According to the Service, longer term projections suggest that about half of the bills and payments that are currently mailed will eventually be replaced with electronic billing and payment alternatives. It is difficult to predict the timing and magnitude of further mail volume diversion to electronic alternatives and the potential financial consequence. Based on anticipated electronic diversion, the Service's baseline forecast in its 5-Year Strategic Plan calls for total First-Class Mail volume to decline at an average annual rate of 3.6 percent from fiscal years 2004 through 2008 (see fig. 6).

Figure 6: Postal Service Projects Decline in First-Class Mail Volume



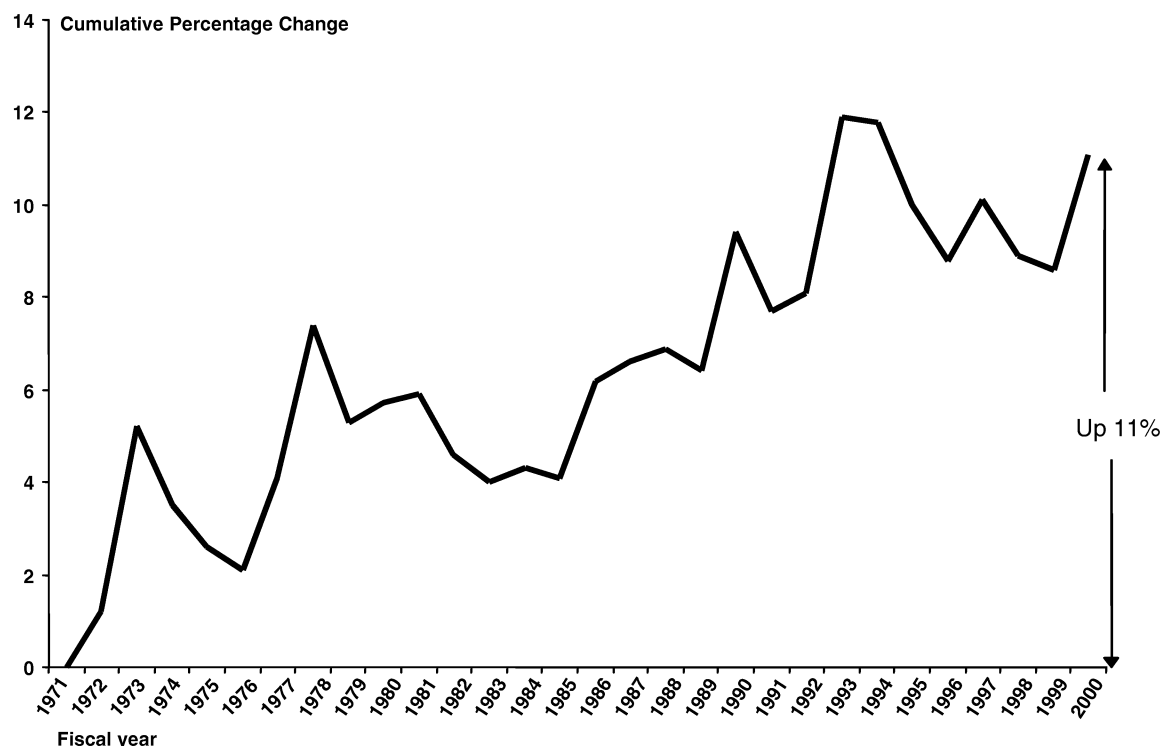
Source: U. S. Postal Service.

The Postal Service has raised the possibility that its financial problems may lead to cutting back universal postal service. A postal official recently said that the Service might ultimately reduce mail delivery from 6 to 5 days each week to remain financially sound. Can the Postal Service continue to maintain the scope and quality of its retail and delivery services? The answer, at least in the short term, is “yes” – but in the long term, the Service’s prospects are uncertain.

Control Costs and Improve Productivity

We have previously reported that the Service's continued success will depend heavily on its ability to control operating costs and improve productivity. Postal productivity—the relationship between the Service's outputs of delivering mail to an expanding delivery network and resources expended in producing them—increased only about 11 percent in the past 3 decades, despite vast changes in automation and information technology (see fig. 7). As the Postal Service and key stakeholders have recognized, long-term increases in its productivity will be essential to controlling costs and thus keeping postage rates affordable. However, numerous reports, including some by us and the Postal Service OIG, have noted inefficiencies in the postal system and difficulties the Service has had in realizing opportunities for savings. The OIG has recently identified potential cost savings and is working to identify further opportunities.

Figure 7: Postal Service Productivity Growth Since Fiscal Year 1971

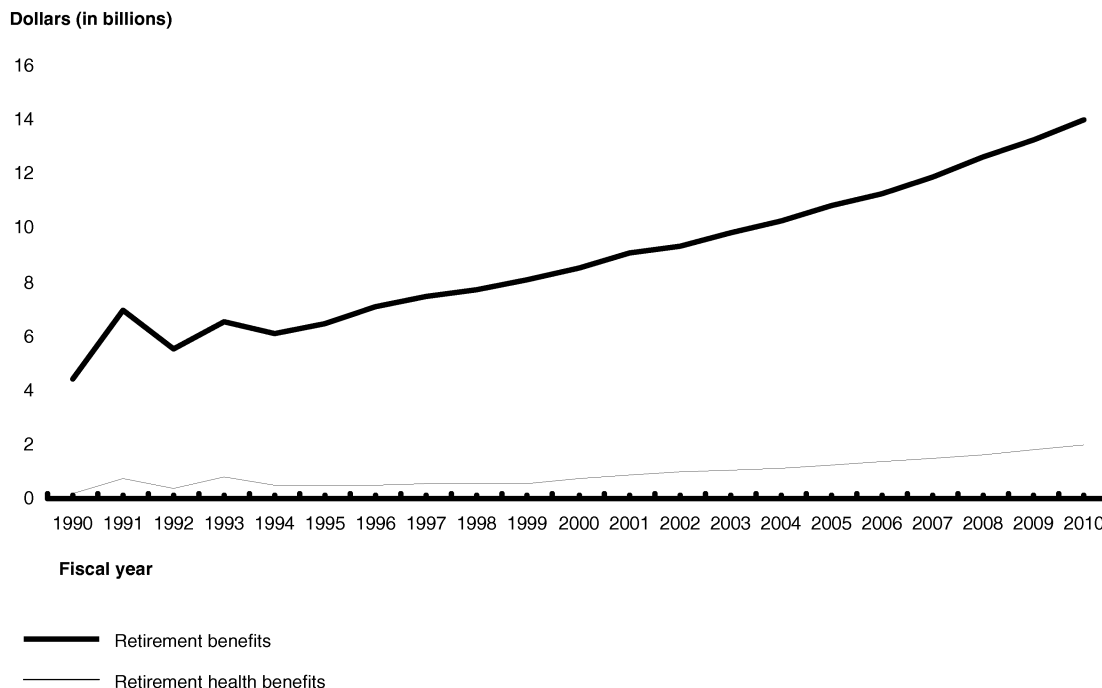


Source: U. S. Postal Service.

The Service's ability to improve productivity and control costs is constrained by a number of factors, such as its requirement to provide postal services to all communities and the requirement that postal wages be determined by binding arbitration when the Service and its labor unions cannot reach agreement. The Service has also reported that extensive work rules and other regulations hamper its flexibility and innovation. In addition, the Service has a self-imposed moratorium on closing post offices and by statute, it cannot close small post offices solely for operating at a deficit. Further, fiscal year 2001 appropriation legislation specifies that the Service cannot close small or rural post offices in fiscal year 2001. The Service estimated several years ago that about half of all post offices do not generate sufficient revenues to cover their costs.

In addition, some employee-related expenses are rising and are difficult to control, such as retirement-related expenses. The Postal Service's retirement-related expenses—that is, the payments the Service makes each fiscal year—have increased in recent years, and these trends are expected to continue (see fig. 8). According to the Service, its retirement expenses are estimated to increase by \$554 million in fiscal year 2001 to \$9.1 billion and are projected to reach \$14.0 billion in fiscal year 2010. In addition, the Service has estimated that its retiree health benefit premium expenses will increase by \$114 million in fiscal year 2001 to \$858 million, and the Service has projected that these expenses will reach about \$2.0 billion in fiscal year 2010.

Figure 8: Postal Service Projects Increases in Retirement-Related Expenses



Source: U. S. Postal Service.

The Service recognizes that it needs aggressive cost management, and the Postmaster General has called for achieving “breakthrough” productivity savings of \$1 billion annually, mainly in mail processing, transportation, and administrative areas. However, the Service’s fiscal year 2001 budget called for saving only \$550 million through such productivity initiatives. The Service is making ongoing efforts to standardize and improve work processes to reduce significant variations in quality, productivity, and costs across the system. The Service is also planning to implement activity-based costing in certain processing facilities to enable it to track activity costs and rates that can be compared across facilities for benchmarking, performance measurement, and budgeting purposes. Another example of potential cost savings that the Service is working to address includes manual processing of mail, which reportedly accounts for half of all labor mail processing costs.

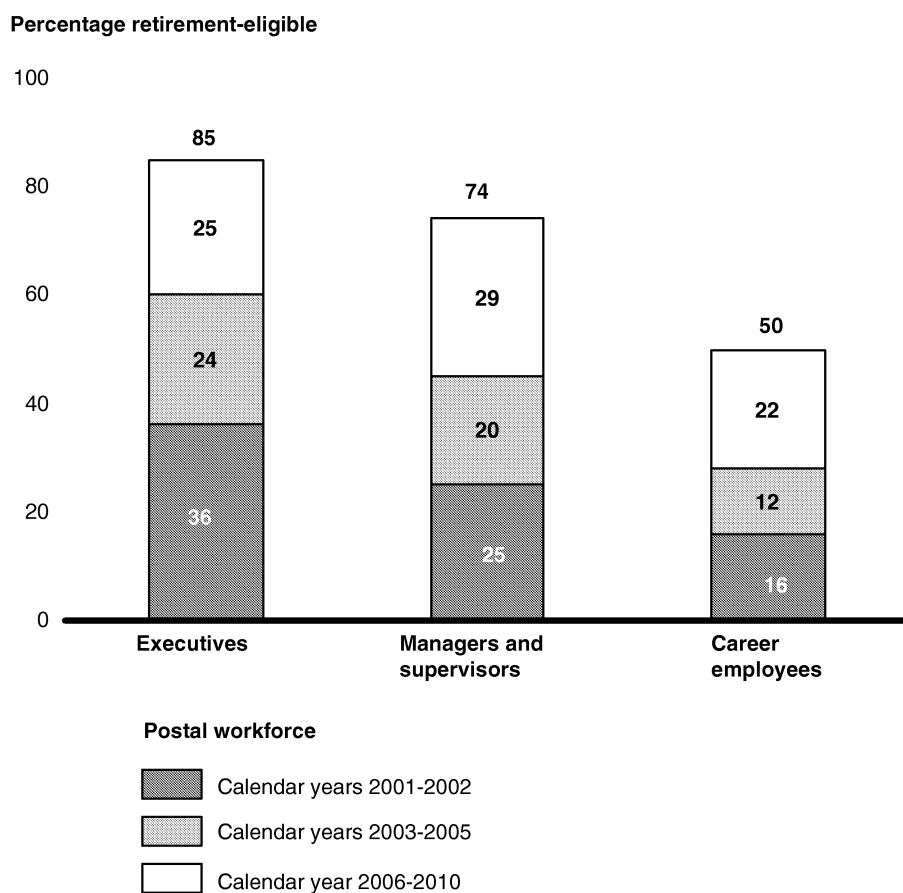
Human Capital Challenges

The Service's Strategic Plan stated that the expected decline in postal workload—in part due to automation and the implementation of information technology—“will inevitably result in both restructuring and a reduction in the workforce.” Some of the planned reductions are to be accomplished through eliminating staff vacancies and the work associated with them. We believe that these reductions should be done in a carefully planned manner to avoid negatively impacting the workplace environment, operations, and service quality. In addition, with a large percentage of the postal workforce nearing retirement eligibility, the Postal Service has the opportunity to reduce the size of its workforce; but the Service will be increasingly challenged to deal with human capital issues related to succession planning, maintaining continuity, and the associated

cost issues. The Service will need to maintain the continuity of service to customers as many experienced managers and workers retire and the Service restructures its workforce.

The Service has projected that among its current employees as of October 2000, in calendar years 2001 and 2002 about 130,000 postal employees are already eligible, or are projected to reach eligibility, for regular retirement. This projection includes 36 percent of executives, 25 percent of managers and supervisors, and 16 percent of the career workforce. By calendar year 2010, 85 percent of postal executives, 74 percent of postal managers and supervisors, and 50 percent of the career workforce will reach retirement eligibility, according to Service projections (see fig. 9).

Figure 9: A Large Percentage of the Postal Workforce Is Nearing Retirement



Source: U. S. Postal Service.

The Postal Service faces additional difficult human capital challenges that must be successfully addressed to maintain organizational effectiveness and improve the workplace environment as well as control workforce costs. These challenges include (1) restructuring the postal workforce of about 900,000 career and non-career employees and reducing the number of employees, and (2) ameliorating persistent problems in the workplace that have been exacerbated by decades of adversarial labor-management relations. The Postal Service's human capital problems can be seen as part of a broader pattern of human capital shortcomings that have eroded mission

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capabilities across the federal government. The Service and its major unions and management associations need to resolve long-standing labor-management problems that have hindered improvement efforts, including efforts to cut costs and increase productivity. In addition, the Service has recognized the need to provide its employees with the tools and incentives necessary to allow effective participation in planning and implementing improvements.

Actions Needed

We are placing the Service's transformational efforts and long-term outlook on our High-Risk List, effective immediately. The Service is at growing risk of not being able to continue providing universal postal service vital to the national economy, while maintaining reasonable rates and remaining self-supporting through postal revenues. A structural transformation of the Service is called for. The Service's financial outlook has deteriorated significantly since last November and it now projects \$2 billion to \$3 billion in expected losses in fiscal year 2001 and an even higher deficit in the next fiscal year if there is no additional rate increase. The Service has been increasing its borrowing and is approaching its \$15 billion debt ceiling without any debt reduction plan. The Service recently deferred capital investment to conserve cash, thus delaying needed improvements and associated gains in efficiency.

In addition, in March 2001, the Postal Service's Board of Governors wrote the President and Congress asking for a comprehensive review of postal laws. The Board said "We have unanimously concluded that the present statutory scheme puts at serious risk our ability to provide consistent and satisfactory levels of universal service to the American people, generally recognized as delivery to every address every day, at uniform, affordable rates." Further, the Service anticipates substantial losses in First-Class Mail volume over the next decade that would create "extreme financial pressure." If the Service experiences a series of large financial deficits, universal postal service could ultimately be threatened, prices would likely increase at a much faster rate, and other options would need to be explored.

While the Service has announced some steps to address its growing challenges, it has no comprehensive plan to address its numerous financial, operational, or human capital challenges. Inclusion of the Postal Service's transformational efforts and long-term outlook on our High-Risk List will focus needed attention on the dilemmas facing the Service before the situation escalates into a crisis where the options for action may be more limited.

The significant shift in the Postal Service's financial outlook in the last 4 months came as a surprise to a variety of key stakeholders. In order to understand the Service's financial and human capital problems, Congress and postal stakeholders need to have frequent, transparent, and reliable information on the Service's current and projected financial situation, the Service's plans to address its growing challenges, and what progress the Service is making. Therefore, we believe the following actions need to be taken:

- The Service should develop a comprehensive plan, in conjunction with Congress and other stakeholders, such as the postal unions and management associations, customers, and the Postal Rate Commission, that would identify the actions needed to address the Service's financial, operational, and human capital challenges and establish a timeframe and specify key milestones for achieving positive results.

- The Service should provide summary financial reports to Congress and the public on a quarterly basis. These reports should present sufficiently detailed information for stakeholders to understand the Service's current and projected financial condition, how its outlook may have changed since the previous quarter, and its progress towards achieving the desired results specified in its comprehensive plan.
 - GAO will work with Congress and the Service to help identify improvement options and will continue to analyze and report to Congress on the Service's ongoing financial condition. In consultation with other postal stakeholders including the Postal Service Office of Inspector General, postal unions and management associations, the Postal Rate Commission, and customers, we will review the Service's financial results and future outlook, progress on cost-cutting and productivity efforts, other countries' experiences, and options for addressing the Service's short-term and long-term challenges.
-

Mr. Chairman, that concludes my prepared statement. I would be pleased to respond to any questions that you or the Members of the Committee may have.

Contact and Acknowledgments

For further information regarding this testimony, please contact Bernard L. Ungar, Director, Physical Infrastructure Issues, on (202) 512-8387. Individuals making key contributions to this testimony included John H. Anderson Jr., Teresa L. Anderson, Hazel J. Bailey, Joshua M. Bartz, Michael J. Fischetti, Jeanette M. Franzel, Melvin J. Horne, Kenneth E. John, Roger L. Lively, Albert E. Schmidt, and Charles F. Wicker.

**TESTIMONY OF POSTMASTER GENERAL,
WILLIAM J. HENDERSON, APRIL 4, 2001
BEFORE THE HOUSE OF REPRESENTATIVES
GOVERNMENT REFORM COMMITTEE**



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**Statement of PMG Henderson before the Committee on Government Reform
U.S. House of Representatives - April 4, 2001**

**Statement of William J. Henderson
Postmaster General and Chief Executive Officer
United States Postal Service
before the Committee on Government Reform,
U.S. House of Representatives
April 4, 2001**

Good morning, Mr. Chairman. I want to thank you and the Members of the Committee for the support and encouragement you have provided during my tenure as Postmaster General. As you know, I will be leaving the Postal Service when my year contract with the Board of Governors expires in May. I appreciate this opportunity to talk with you about where we are in the Postal Service today and at the future of this institution.

The Postal Service stands on the cusp of what should prove to be its most dynamic and rewarding century of service to the American people. Within the postal community as a whole, the challenge is to update a shared vision of what the Postal Service can and should be in today's fluid environment, and to install the incentive and tools to get what the Nation wants from it.

Since becoming Chief Operating Officer in 1994, what I have found is an organization eager to set high expectations for itself, and to make the commitment necessary to exceed them.

Seven years ago, when our on-time performance numbers for overnight local delivery of First-Class Mail averaged in the low 80s, who would have thought that 93 percent was physically achievable, especially in the big urban areas like Washington and New York? But we're now working on a fourth year in a row at 93 percent or better. In our independent Customer Satisfaction Measurement, the percentage of people rating the Postal Service "excellent" has doubled over the same time period. The managers and employees of the Postal Service put a lot of hard work into these achievements, and I'm proud of what they have accomplished.

Over this period, the Postal Service has experienced some of the best growth in revenue volume in its history. We invested heavily to expand automation and technology for improved productivity. In the year 2000, Total Factor Productivity grew by 2.5 percent, the best record since 1993.

During the last seven years we have also succeeded in holding down the prices that customers have had to pay. The last two rate increases were among the smallest and most affordable in the history of the Postal Service.

Since 1994 the Postal Service also posted some of its best financial results, including four years in a row with net income, prior to Fiscal Year 2000.

As you know, in recent months the Postal Service's finances, along with the economy in general, have taken an unfavorable turn. Our latest forecasts project losses in the range of \$2-3 billion for this Fiscal Year.

Through our Accounting Period 6 ending February 23, our revenue fell below plan \$344 million, or 1.1 percent. Compared to the same period last year, revenue was only 1.8 percent, despite the recent rate increase. In the first quarter, including the holiday season, First-Class Mail volume actually dropped, for the first time in year. More recently it is almost flat. After years of growth, usage of our high-margin product, Priority Mail, is in decline.

Costs are only slightly over plan at this point, despite growth in several components that are beyond our control, including fuel prices and arbitrated wage awards.

In the face of this adversity, the Postal Service, as currently structured, unfortunately has only rather blunt instruments available to it.

- Our finances are structured to be hand-to-mouth. Break even means that prices and costs are supposed to stay in balance, and the Postal Service cannot build earnings for the longer term like a private firm.
- The process for adjusting rates is largely outside the Postal Service's control.
- It takes a large, cumbersome, slow omnibus rate proceeding to align prices with changing costs.
- While the Governors have final responsibility for rates, including some modification authority, this option arrives late in the process when much of the damage may already have occurred.
- The nature of basic service obligations and networks remains fixed, and the numbers of customers to be served grows, whether the economy is booming or soft.
- The law allows multi-billion-dollar wage decisions to be passed to unaccountable outside arbitrators, so that the parties escape the responsibility to work out the organization's future themselves.

All of this makes the Postal Service uniquely vulnerable to rapid shifts in its market. The current financial challenge arises against a backdrop of explosive growth in communications technology and revolutionary restructuring of the commercial marketplace. Previous commercial relationships among service providers and between providers and customers are changing at an unprecedented pace and on a global scale.

The question to be asked is, can we reasonably expect at this point that the Postal Service will regain the steady progress it made in the 1990s, without a major modernizing reform? I doubt it.

Across the world the answer other advanced countries have reached for their own postal systems is no. They already have revolutionary commercial reforms of their postal systems well underway, and the officials I talk to cannot understand how the United States would choose to lag behind.

Mr. Chairman, with your permission, I would like to personally thank Congressman John McHugh for the leadership he has shown over the last five years, in taking up and carrying forward the mantle of postal reform. I continue to believe that this country will ultimately choose to move to a more commercially viable postal structure required to meet our current and future challenges. When that happens, John's efforts will deserve much of the credit for giving this problem the visibility and recognition it deserves.

I do not know that postal reform must follow any one model, or be achieved in a single stage. But I am certain that, to be successful, reform must provide the opportunity, the incentives, and the accountability for the Postal Service to evolve with its markets. Without an ability to probe for new ways of doing business and to rapidly adjust to forces of demand and competition, the postal system will become increasingly outmoded, and will have trouble meeting its very important responsibilities to the public.

Universal service for all Americans in every corner throughout the length and breadth of this country has been the hallmark of a growing, healthy Postal Service over its entire history. A seriously weakening postal system would find it more and more difficult to carry the full load of universal service, where the volume of traffic does cover the full cost.

In recent years the Postal Service has invested increasing attention in improving customer focus and seeking opportunities for new methods, products, and service. We want to take full advantage of the efficiency and better service that technological progress and new business relationships can provide for the benefit of our customers. Our recent business alliance with FedEx is just one example. An ongoing process of creative reinvention and reorientation will be required to enable the Postal Service to maintain and improve its relevance for the American public in the years ahead.

During my time as Postmaster General and before that as Chief Operating Officer, I believe the Postal Service has proved that it is willing and determined to make the changes necessary to stay up to date and maintain the value of its service. It is clear, however, that the current legal structures for regulation and governance of the postal system do not provide enough incentives and tools for change. The present structures are heavily biased toward maintaining the status quo. Risk-taking is discouraged and any mistake is punished. Every initiative that would change the way things have been done before immediately incurs a heavy burden of persuasion.

The bottom line is that the postal community collectively is accustomed to holding the Postal Service on a short rope. Checks and balances are valued more than innovation and improvement. Over the longer term, in the fast-paced world of communications today, this is a formula for growing irrelevance, weakening service, declining usage, spiraling costs and prices - a formula for increasing obsolescence and failure.

The solution is not unfettered commercial freedom, but greater application of market-based controls and accountability. This is the direction that offers the best return for the American people. It is the direction that our trading partners overseas are taking. And in one form or another, it is the direction we need to take in this country, and I take, in my opinion. For the sake of a smooth transition and as little disruption as possible, both for the general public and for the huge section of American commerce that is so heavily reliant on the Postal Service, reform sooner is better than reform later.

Thank you very much, Mr. Chairman. I will be pleased to respond to questions.

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**POSTAL SERVICE BOARD OF GOVERNORS' LETTER,
MAY 15, 2001
TO CONGRESS**



May 15, 2001

Honorable Fred Thompson
Chairman
Committee on Governmental Affairs
United States Senate
Washington, DC 20510-6250

Dear Mr. Chairman:

This provides some suggestions from the Board of Governors regarding needed postal reforms, as discussed in my testimony this morning. Simultaneously, I am also providing these same comments to the Chairman of the House Committee on Government Reform at his invitation.

Reform must ensure that the Postal Service is able to carry out the universal service mission given to it by Congress. To achieve this end, reform should be as simple and understandable as possible, drawing from familiar marketplace models to the maximum extent consistent with the retention of universal service. Market solutions should be possible to bring needed reform to the critical areas of labor and employment and to protect the financial viability of universal service. We have enclosed summaries describing the principles that we would like to see guiding reform in each of these areas.

We believe that regulatory reform is needed for the preservation of universal service in a changing marketplace. Adjustments in pricing and products should be handled as much as possible as in any other business. The Postal Service should have an explicit universal service requirement to continue to provide regularly scheduled, daily delivery of letters in all urban and suburban neighborhoods and rural communities throughout the country, at affordable prices. The monopoly protection properly associated with supporting that obligation should be retained. We recognize that a level of regulation is required for the protection of universal service and the public interest in a monopoly environment. Regulatory intervention should be structured so that the Postal Service has the ability to attune its efforts to market forces as nearly as possible. This could be accomplished through application of an easy to understand indexing mechanism for services covered by the explicit universal service requirement, and through market pricing for all other services.

Without genuine market-driven reforms, it is not reasonable to expect that the Postal Service will be able to meet its universal service responsibilities indefinitely, as the protection of the postal monopoly is diminished in the market. With sufficient flexibility, we believe that a more businesslike Postal Service should be able to improve efficiency and financial viability. Only in this way can Congress expect to preserve the Postal Service's unique contribution as the last delivery mile, assuring access for all America.

For an organization as labor-intensive as the Postal Service, reform will be deficient and ineffective unless it also addresses the shortcomings of the current labor and employment process. In our view, the system fails the public interest when it delegates the most vital decisions about wages and working conditions to an outside arbitrator having no accountability for the future of postal services for the people of the United States. The private sector model for labor relations in organizations that provide essential services is designed to induce management and employees to decide their own future together, while also protecting the public interest with mechanisms for public input where needed. Drawing on that model, postal reform should be able to improve the accountability of this key ingredient of the Postal Service's performance. For other employment matters, the Postal Service should also be expected to operate more like a business.

I appreciated the opportunity to discuss the challenges facing the Postal Service at the Committee's hearing, and look forward to continuing to work with you to see that all Americans have the best possible postal services.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert F. Rider", written in a cursive style.

Robert F. Rider
Chairman

Enclosure

FINANCIAL VIABILITY OF UNIVERSAL SERVICE

Current Law. By statute Congress requires the Postal Service to provide a maximum degree of effective and regular postal service in all communities throughout the country, including places where services are not self-sustaining. To cover costs, the law contemplates that the Postal Service will be able to maintain enough contribution from its overall business to offset the shortfall on economically unsustainable routes and services. In support of universal service obligations, the Private Express Statutes reserve the core of the letter delivery business to the Postal Service.

The law also relies on a regulatory model of control, in preference to market-based principles. To change prices or mail classification for domestic postal services, the Postal Service must first develop a voluminous evidentiary case for presentation before the Postal Rate Commission (PRC). In a pricing case, the PRC then has 10 months to receive the views and evidence of interested parties and issue a recommended decision to the Governors of the Postal Service for final action. The PRC develops its pricing decisions based on cost of service principles. Each subclass must cover the costs found attributable to it, plus a reasonable share of the institutional or overhead burden of the system. Institutional costs are assigned among the various subclasses based on statutory policy criteria such as fairness and equity, impact on customers and on competition, and educational, cultural, scientific, and informational value. Product and service classifications are also based on consideration of statutory criteria, including fairness and equity and the relative value of kinds of mail matter.

Deficiencies. The process for adjusting prices and services is long and cumbersome, typically requiring the major portion of two years from preparation to implementation. Economic and market factors are largely subordinated in the pricing policies prescribed in the current law, not only for monopoly services, but also for those services highly vulnerable to competing services or substitutes. While competitors often adjust their prices gradually, the long regulatory process tends to force postal price changes in large increments. All of these factors tend to make the Postal Service lag well behind developments in the economy and in the marketplace. As technology and market forces open up more and more of the mail stream to the threat of competitive diversion, the financial viability of the Postal Service is undermined. Universal service at affordable prices for all areas, including those hardest to serve, is placed at risk.

Some of these limitations are illustrated by the arduous course of the most recent rate proceeding. In retrospect, the case attempted to use previous experience from a long period of economic expansion to forecast needs for a time when the economy has slowed unexpectedly. As a result, the Postal Service is now providing universal service without fully covering the cost. The current regulatory system also discourages reasonable businesslike innovations to maximize total contribution, such as seasonal pricing and contract pricing.

Proposal. Reforms are needed to provide a better opportunity for the Postal Service to manage its business on behalf of the public as nearly as possible in line with market forces, consistent with the preservation of universal service. The Postal Service should have an explicit universal service requirement. This should cover regularly scheduled, daily delivery of letters in all urban and suburban neighborhoods and rural communities

throughout the country, at affordable prices. The monopoly provisions necessary to support this universal service requirement should be continued. High-volume routes serving business concentrations and affluent residential areas would be attractive targets for competitors who lack the same universal service responsibilities. For services outside the scope of the universal service requirement, the Postal Service should be expected to manage itself like a business, within a market environment.

Pricing regulation should be updated to introduce incentives for the Postal Service to operate more in accordance with market requirements while sustaining universal service. Results-oriented regulation should define broad expected outcomes, and the Postal Service should have responsibility to manage its business as needed to supply the defined level of performance for the American people.

For service covered by the explicit universal service requirement, the regulator should administer an indexing system, under which the Postal Service is encouraged to perform efficiently, and the public interest in fair and affordable rates is protected. The system should be simple and readily understandable, not cumbersome and complex. For all other services, the Postal Service should have the room to price according to market conditions in a businesslike way.

In place of the current mail classification process, the regulator should also limit its focus to service within the scope of the universal service requirement. In all other areas, the Postal Service should be able to adjust its products and services or introduce new ones as needed to advance its overall performance for the American people. Letter service, by itself, will not pay the cost of a universal service network reaching all communities and neighborhoods. Other services that fill mailbags or serve postal customers in associated ways in the market are needed to help fund universal coverage.

These changes would help to preserve universal service by positioning the Postal Service to function as an integral part of today's increasingly dynamic, technology-driven, global markets. As the traditional and newer economies continue to merge, letter monopoly protections will not be sufficient alone to preserve universal service. To maintain financial integrity, the Postal Service will have to be able to function as a thriving business in the marketplace. Under increasingly challenging conditions, revenue from stagnant or declining mail volume would not meet the cost of a growing universal service network at affordable rates, as the nation itself continues to grow. Only by joining with its customers to match their own immersion in the 21st Century economy can the Postal Service maintain the relevance and financial integrity of a universal postal system binding all of the nation together.

LABOR AND EMPLOYMENT REFORM

Collective Bargaining

Current Law. The impasse resolution procedure currently follows a public sector model featuring compulsory binding arbitration. When the parties in negotiation fail to reach agreement, the statute provides initially for a voluntary fact-finding process, led by a panel of three persons chosen by the Federal Mediation and Conciliation Service. If that process fails to produce agreement, or, as is typically the case, the parties choose not to engage in fact-finding, both sides then select a partisan arbitrator, and the two thus selected choose a third, neutral arbitrator to settle unresolved issues. In practice, the neutral arbitrator then issues an award imposing a new labor contract.

Deficiencies. The current process fails to require the parties to resolve critical workplace issues controlling the ability of the Postal Service to meet its responsibilities. The process does not encourage and enable change. In a period in which competitive and technological forces press the Postal Service to evolve rapidly to meet new challenges, the process has proved unable to accommodate significant progress. Critical issues of national policy have been left to a series of individual arbitrators having no public accountability for the results. Since 1981, 13 out of 20 labor contracts with the Mail Handlers, National Association of Letter Carriers, and American Postal Workers Union were resolved in interest arbitration. While such decisions substantially determine the largest component of Postal Service costs, the underlying interests of Postal Service customers and the American public are not required to be taken into account by the arbitrator.

Proposal. Postal collective bargaining should be reoriented based generally on the private sector model for essential services, most prominently reflected in the Railway Labor Act. This process brings to bear more intensive mediation procedures designed to lead the parties to reach their own resolution of the issues, and includes an opportunity for public policy input at the highest level, before a party can resort to self-help through strike or lockout. In addition, a specific detailed standard, reflecting the public interest, should be used in establishing the terms of the collective bargaining agreements.

If the initial negotiation period is not successful, a mediator of stature would be appointed by the National Mediation Board. The mediator would explore the differences between the parties in light of detailed standards reflecting the public interest, including—

- the interests and welfare of all postal customers
- a comparison of wages with the wages of other employees performing the same or similar services in the entire private sector
- the overall compensation presently received by employees, including wages, vacations, holidays, insurance, pensions, medical and hospitalization benefits, the continuity and stability of employment, and all other benefits received.

- relevant economic factors, including the previous financial record of the Postal Service, its present financial health, and anticipated future economic circumstances.

If the parties still failed to reach agreement, and did not provide for voluntary interest arbitration, the National Mediation Board could impose one or more cooling off periods. By executive order, the President could direct the appointment of a Presidential Emergency Board, with three neutral members, to explore the issues and provide a non-binding report. In making determinations, the Board would give due weight to the same statutory factors considered earlier by the mediator. Only if all of these measures failed, and Congress did not intervene to impose a settlement as it has done in several instances under the Railway Labor Act to protect the national interest, would the union be able to strike or the employer, to lockout employees.

Other Employment Reforms

Current Law. Presently, a number of employment benefits are subject to change from time to time by legislation, including pension and certain cost-of-living benefits for employees in remote locations. In addition, Postal Service salaries are capped by reference to the level paid to federal Cabinet officers. The law also overlays certain governmental personnel regulation outside the control of the Postal Service and its employees, including adverse action appeals to the Merit Systems Protection Board.

Deficiencies. Allowing benefits to change or adverse actions to be regulated both at the bargaining table and through legislation undermines the integrity of the bargaining process. This is a loophole excluding vital components of the postal job environment and major factors in the cost of its services from determination by management and labor together, with regard for the impact on their future and their customers. For example, in the past year employees received new Long Term Care insurance coverage and expanded Thrift Savings Plan options by legislation, without having to bargain for them. While, by law, wages and benefits are broadly intended to be comparable to those paid in the private sector, the upper limit on salaries prevents the Postal Service from approaching comparability at the executive level. This constraint adds to the difficulty in maintaining competitive services that will enable the Postal Service to retain the overall financial base required to pay for universal service at affordable rates.

Proposal. First, all future changes to all pension, insurance, medical and hospitalization benefits (including retiree health care), and any other changes to the hours or conditions of employment should be the subject of collective bargaining for bargaining-unit employees, rather than changed by legislation. Second, the limitation on maximum compensation should be eliminated. The Postal Service should provide compensation for officers, executives, and other non-bargaining-unit employees comparable to what is paid for comparable positions in the private sector of the economy. Third, the Postal Service and its employees should have full responsibility for adverse action procedures and other aspects of the employment relationship.



May 15, 2001

Honorable Dan Burton
Chairman
Committee on Government Reform
House of Representatives
Washington, DC 20515-6143

Dear Mr. Chairman:

This responds to your invitation at the April 4 oversight hearing for suggestions from the Board of Governors regarding the shape of postal reform. Simultaneously, I am also providing these same comments to the Chairman of the Senate Committee on Governmental Affairs.

Reform must ensure that the Postal Service is able to carry out the universal service mission given to it by Congress. To achieve this end, reform should be as simple and understandable as possible, drawing from familiar marketplace models to the maximum extent consistent with the retention of universal service. Market solutions should be possible to bring needed reform to the critical areas of labor and employment and to protect the financial viability of universal service. We have enclosed summaries describing the principles that we would like to see guiding reform in each of these areas.

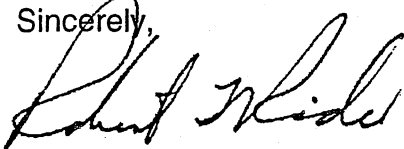
We believe that regulatory reform is needed for the preservation of universal service in a changing marketplace. Adjustments in pricing and products should be handled as much as possible as in any other business. The Postal Service should have an explicit universal service requirement to continue to provide regularly scheduled, daily delivery of letters in all urban and suburban neighborhoods and rural communities throughout the country, at affordable prices. The monopoly protection properly associated with supporting that obligation should be retained. We recognize that a level of regulation is required for the protection of universal service and the public interest in a monopoly environment. Regulatory intervention should be structured so that the Postal Service has the ability to attune its efforts to market forces as nearly as possible. This could be accomplished through application of an easy to understand indexing mechanism for services covered by the explicit universal service requirement, and through market pricing for all other services.

Without genuine market-driven reforms, it is not reasonable to expect that the Postal Service will be able to meet its universal service responsibilities indefinitely, as the protection of the postal monopoly is diminished in the market. With sufficient flexibility, we believe that a more businesslike Postal Service should be able to improve efficiency and financial viability. Only in this way can Congress expect to preserve the Postal Service's unique contribution as the last delivery mile, assuring access for all America.

For an organization as labor-intensive as the Postal Service, reform will be deficient and ineffective unless it also addresses the shortcomings of the current labor and employment process. In our view, the system fails the public interest when it delegates the most vital decisions about wages and working conditions to an outside arbitrator having no accountability for the future of postal services for the people of the United States. The private sector model for labor relations in organizations that provide essential services is designed to induce management and employees to decide their own future together, while also protecting the public interest with mechanisms for public input where needed. Drawing on that model, postal reform should be able to improve the accountability of this key ingredient of the Postal Service's performance. For other employment matters, the Postal Service should also be expected to operate more like a business.

The Board very much appreciates the Committee's exhaustive, trail-blazing efforts in the cause of postal reform, and your personal leadership as reflected most recently in your efforts to engage the new Administration. I think we all agree that the environment in which the Postal Service operates now demands a postal system held accountable to act much more like a business than is possible under the current 30-year-old legislation. We appreciate your courtesy in inviting our views and look forward to continuing to work with you to see that all Americans have the best possible postal services.

Sincerely,

A handwritten signature in dark ink, appearing to read "Robert F. Rider", written in a cursive style.

Robert F. Rider
Chairman

Enclosure

**TESTIMONY OF COMPTROLLER GENERAL,
DAVID WALKER, MAY 15, 2001
BEFORE THE SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS,
SUBCOMMITTEE ON INTERNATIONAL SECURITY, PROLIFERATION,
AND FEDERAL SERVICES**



Testimony

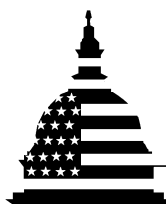
Before the Committee on Governmental Affairs
and its Subcommittee on International Security,
Proliferation, and Federal Services
U.S. Senate

For Release on Delivery
At 10:00 a.m. EDT
Tuesday,
May 15, 2001

U.S. POSTAL SERVICE

Financial Outlook and Transformation Challenges

Statement by David M. Walker
Comptroller General of the United States



G A O

Accountability * Integrity * Reliability

Mr. Chairman and Members of the Committee and Subcommittee:

We are pleased to be here today to participate in this joint hearing on the financial outlook and transformation challenges of the U.S. Postal Service (the Service). Overall, the Service faces major challenges that collectively call for a structural transformation if it is to remain viable in the 21st century. Your Committee and Subcommittee have expressed concern with the Service's deteriorating financial outlook. In my testimony today, I will focus on the Service's current financial outlook, actions the Service has taken or planned, and the transformation issues that will need to be addressed.

Summary

A structural transformation of the Service is called for because the Service faces major financial, operational, and human capital challenges. It is at growing risk of not being able to continue providing universal postal service vital to the national economy at reasonable rates while remaining self-supporting through postal revenues. Accordingly, in April 2001, we placed the Service's transformational efforts and long-term outlook on our High-Risk List. This inclusion on our High-Risk List will focus needed attention on the dilemmas facing the Service before the situation escalates into a crisis where the options for action may be more limited and costly.

Key factors contributing to our decision to place the Service's transformational efforts and long-term outlook on our High-Risk List included the following:

- The Service's financial outlook has deteriorated significantly, its borrowing is increasing, and the Service's debt is approaching the \$15 billion statutory ceiling without any debt reduction plan. Also, the large number of retirements expected over the next several years will place even more pressure on the Service's expenses and its need for cash.
- The Service recently deferred capital investment to conserve cash, thus delaying needed infrastructure improvements. These deferrals appear likely to continue.
- In March 2001, the Postal Service's Board of Governors wrote the President and Congress asking for a comprehensive review of postal laws. The Board said "We have unanimously concluded that the present statutory scheme puts at serious risk our ability to provide consistent and satisfactory levels of universal service to the American people, generally recognized as delivery to every address every day, at uniform, affordable rates."
- Potential losses in First-Class Mail volume over the next decade could create large financial deficits, leading to a situation where universal postal service could ultimately be threatened, prices would likely increase at a much faster rate, and other options would need to be explored.
- The Service is subject to several statutory and other restrictions that serve to limit its transformational efforts (e.g., binding arbitration requirement, the rate-setting process, and facility closure restrictions).
- The Service has also had periodic conflicts with some of its key stakeholders including postal unions and the Postal Rate Commission. We have noted longstanding

labor-management relations problems that have hindered improvement efforts, including three labor agreements that expired in November 2000 and may now be resolved through binding arbitration. In addition, the Postal Service and the Postal Rate Commission have had longstanding disagreements concerning pricing decisions.

- Finally, two key leadership positions need to be filled relating to postal operations and rate setting (Postmaster General and Chairman of the Postal Rate Commission).

Although the Service has announced some steps to address its growing challenges, it has no comprehensive plan to address its numerous financial, operational, or human capital challenges. In April 2001, we recommended that the Postal Service develop a transformation plan in conjunction with Congress and other stakeholders that would address the key transformation issues facing the Service.¹ Service officials told us that they generally agree with the recommendation. I recently met with the Deputy Postmaster General, and we discussed ways that the Service could implement it.

We appreciate the difficulty of this task, given the long-standing nature of the structural problems and major differences in stakeholders' views. But the sense of urgency is growing. The basic statutory framework that governs the Postal Service has not changed since 1970, despite the fact that developments in technology and a more competitive marketplace provide more communications and delivery choices to businesses and consumers. The Service's ability to provide universal postal service as we know it today will be increasingly threatened unless changes are made, both within current law and to the legal and regulatory framework that governs the Service.

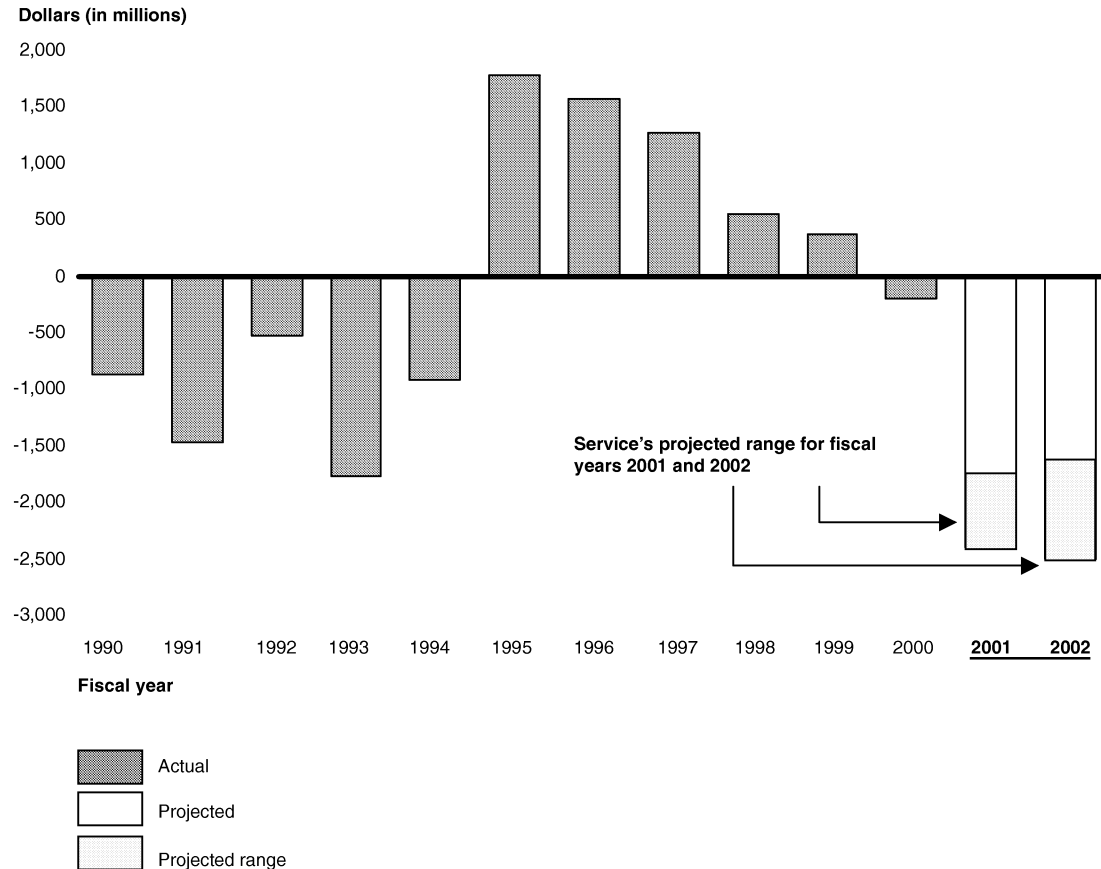
What is the Service's Current Financial Outlook?

The Service is projecting significant losses over the next 2 years, although the full extent of the losses is unclear. The Service currently estimates that its fiscal year 2001 deficit will range from \$1.6 billion to \$2.4 billion and also estimates that its deficit will be \$1.5 billion to \$2.5 billion next fiscal year, assuming no further increase in postal rates next year. If such deficits occur, they could be the largest that the Service has incurred since fiscal year 1993 (see fig. 1).

The Service's latest deficit projections for fiscal years 2001 and 2002 incorporate the expected impact from its Board of Governor's recent decision to raise most postal rates on July 1, 2001 (the rate for single-piece First-Class mail of up to 1 ounce will remain at 34 cents). Service officials estimate that the higher rates will increase its revenues by about \$200 million in fiscal year 2001 and about \$975 million in fiscal year 2002.

¹ *U.S. Postal Service: Transformation Challenges Present Significant Risks* (GAO-01-598T, April 4, 2001).

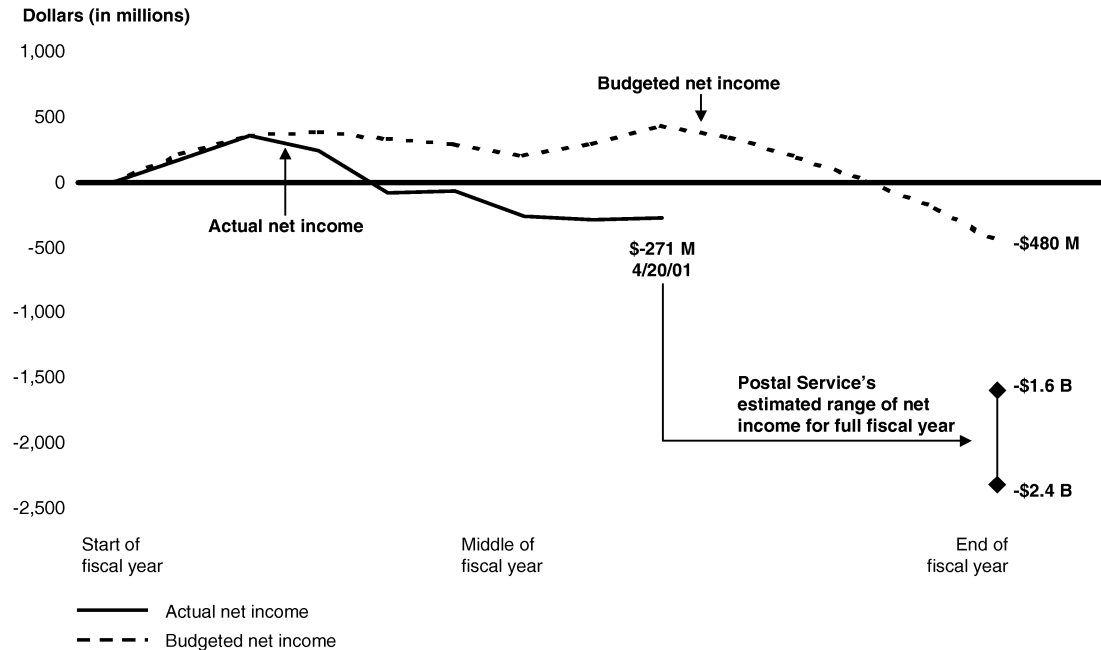
Figure 1: Postal Service Net Income From Fiscal Year 1990 through 2002



Source: U.S. Postal Service.

The Service's estimated fiscal year 2001 deficit of \$1.6 to \$2.4 billion far exceeds the \$480 million deficit built into the Service's budget that was approved last November. About \$271 million of the Service's current deficit projections were based on reported losses through the end of the Service's accounting period ending April 20, 2001, and the rest is based on projected losses for the rest of the fiscal year (see fig 2).

Figure 2: The Postal Service's Net Income for Fiscal Year 2001



Source: U.S. Postal Service.

The Service's current deficit estimate of \$1.6 billion to \$2.4 billion for fiscal year 2001 is roughly half a billion dollars lower than the Service's estimate we cited in our April testimony of a \$2.1 billion to \$3.1 billion loss. According to Service officials, the less pessimistic outlook is due to three factors. First, the Service reports making additional progress in controlling costs, and expects that progress to continue for the rest of the fiscal year. Second, the Service expects to gain revenues as a result of its recent decision to raise most postal rates on July 1, 2001. Third, the Service updated its projections about the potential effect of the soft economy on postal revenues for the rest of the fiscal year.

Although the Service appears headed for a large deficit in fiscal year 2001 and has explained its basis for the estimates to us, we believe that too many uncertainties exist to predict the size of this year's deficit at this time with any precision. The Service's financial outlook is a moving target and may change, depending on the resolution of uncertainties that could affect its revenues and expenses for the rest of this fiscal year. For example, the impact of the economy on postal revenues remains somewhat unclear, as are the financial implications of the ongoing contract negotiations between the Service and three of its major labor unions. We will continue to review the Service's financial condition and will report again to Congress on this matter. Regardless of the exact size of the Service's deficit, the severity of the Service's financial situation is highlighted by the fact that a large deficit is likely to occur despite two rate increases in the same year.

Components of the Service's Projected Deficit for Fiscal Year 2001

The Service's projected deficit for fiscal year 2001 can be divided into the following categories: (1) \$271 million in reported losses through the end of the Service's accounting period ending April 20, 2001, (2) \$911 million in budgeted losses for the rest of the fiscal year, (3) \$120 million in expenses projected to *exceed* budgeted targets for the rest of the fiscal year, (4) \$155 million in revenues projected to *fall below* budgeted targets for the rest of the fiscal year because the Service did not initially receive the full rate increase it had requested, and (5) \$150 million to \$950 million in revenues projected to *fall below* budgeted targets for the rest of the fiscal year due to the soft economy and its impact on mail volume and revenues (see fig. 3). The \$800 million deficit range reflects the Service's judgment that the soft economy will have an uncertain impact on its revenues.

Figure 3: Changes in the Postal Service's Financial Outlook for Fiscal Year 2001

	Budgeted	Current
Reported Net Income: As of 4/20/01	\$431 M	-\$271 M
Originally Budgeted Net Income: 4/21/01 - FY-end	-\$911 M	-\$911 M
Expense Adjustments to Net Income: 4/21/01 - FY-end		-\$120 M
Revenue Adjustments to Net Income: 4/21/01 - FY-end		-\$155 M
Subtotal		-\$1.5 B
Other Revenue Adjustments to Net Income: Soft Economy - 4/21/01 - FY-end		-\$150 M to -\$950 M
Net Income	-\$480 M	-\$1.6 to -2.4 B
FY 2001 Revised Deficit \$1.6 to \$2.4 B		

Legend: Dollars in millions (M), billions (B).

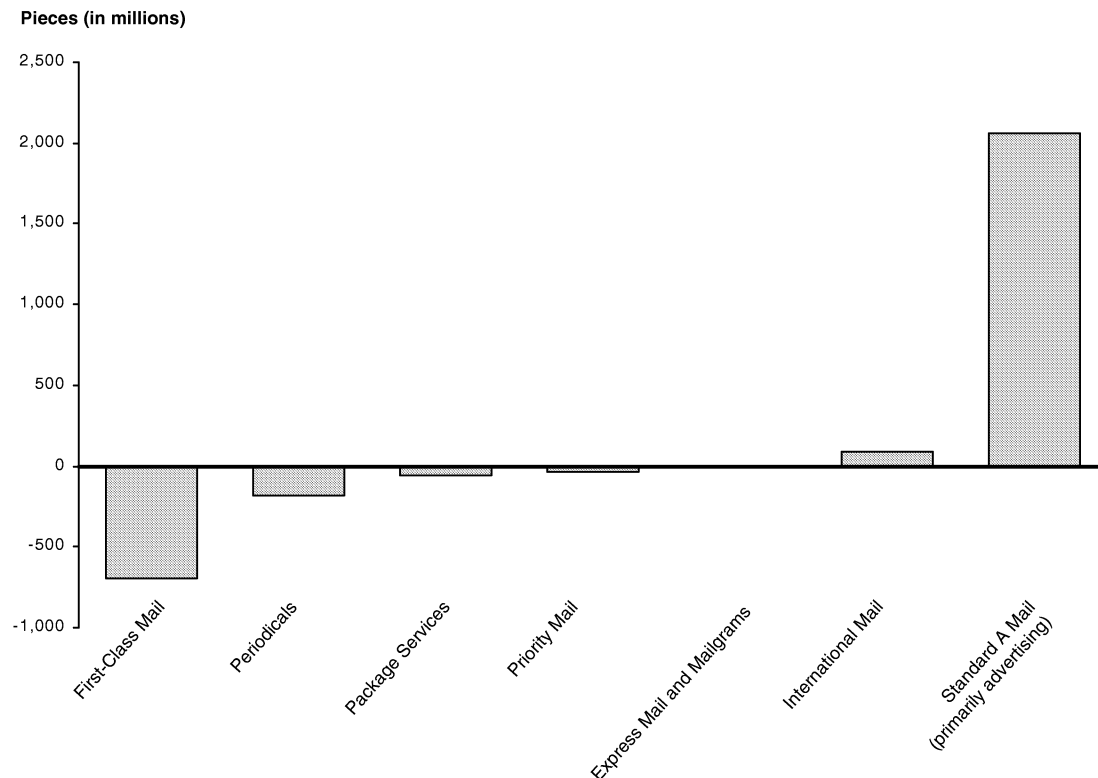
Source: GAO presentation based on U.S. Postal Service estimates, which are subject to change.

Reported Losses for the First Part of Fiscal Year 2001

As figure 3 shows, the Service reported that its loss for the first part of this fiscal year through April 20, 2001, was \$271 million. This reported amount is not audited and is subject to change. Historically, the Service's financial performance tends to be stronger in the first part of the fiscal year, which includes the busy holiday mailing season. The Service budgeted for a \$431 million surplus through April 20, therefore, its net income fell \$702 million below this target. To put some perspective on the Service's income estimates, in the first part of last fiscal year, the Service achieved \$1.1 billion in net income but ended the year with a net loss of \$199 million.

Through April 20 of fiscal year 2001, total mail volume continued to grow, and it was also greater than that planned for by the Service in its fiscal year 2001 budget. In particular, Standard A advertising mail volumes grew more rapidly than the Service had expected. At the same time, however, some mail volumes were less than what the Service had planned for in its budget, particularly First-Class Mail and Priority Mail volumes (see fig. 4).

Figure 4: Mail Volume for FY 2001 Through April 20, 2001 Compared to Budgeted Levels



Source: U.S. Postal Service.

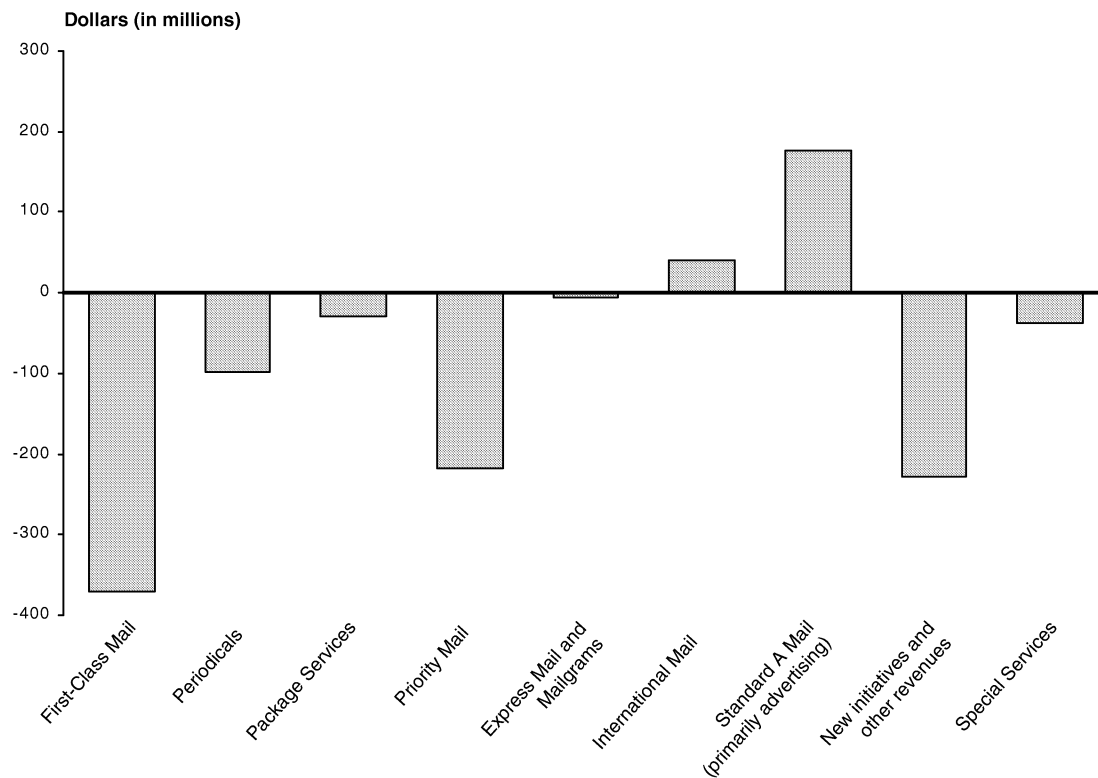
These mail volume shortfalls contributed to the Service's mail revenues being less than budgeted for in the first part of fiscal year 2001. First-Class and Priority Mail, when combined, account for close to two-thirds of the Service's mail revenues and generate revenues that pay for approximately three-quarters of the Service's overhead costs. Thus, the Service cites the shortfalls in First-Class Mail and Priority Mail volume as important reasons that its total revenues have fallen short of budgeted targets. The Service has also noted that Standard A advertising mail is lower margin mail in that each mail piece generates less money toward overhead costs than each piece of First-Class Mail and Priority Mail.

In addition, the Service has estimated that the decision by the Postal Rate Commission to not recommend the full rate increase requested by the Service will lower its total revenues by \$390 million this fiscal year, including \$235 million in the fiscal year through April 20.

Further, the Service incurred a shortfall of \$228 million from other types of revenue that included a \$138 million shortfall in planned revenue from e-commerce, advertising, and retail initiatives. These initiatives generated only \$2 million in revenues in fiscal year 2001 through April 20. The Service explained that as experience with its new ventures progresses, it has become clear that the business plans were overly aggressive.

Figure 5 shows the Service's total revenues, including shortfalls in various mail categories, special services,² and other types of revenue.

Figure 5: Revenues for FY 2001 Through April 20, 2001 Compared to Budgeted Levels



Source: U.S. Postal Service.

The Service's expenses in fiscal year 2001 through April 20 were about the same as its budgeted target of \$41.9 billion—with reported expenses \$50 million below this target, a difference of 0.1 percent. During this period, First-Class Mail and Priority Mail volumes fell below expected levels. Service officials have told us that the cost of handling First-Class Mail and Priority Mail did not decline commensurate with the decline in volume because it is difficult to make such a short-term adjustment. Moreover, the Service incurred additional costs to handle higher-than-expected increases in other mail volumes, particularly Standard A advertising mail. Thus, the Service's overall workload was higher than it had budgeted for. As a result, some compensation and other costs were reported to be higher than budgeted, but these additional costs were fully offset in the first part of the fiscal year by cost reductions in other areas.

² Special services include registered and certified mail, postal money orders, and post office boxes, among other things.

Budgeted Losses for the Rest of Fiscal Year 2001

In its fiscal year 2001 budget, the Service estimated that it would incur a \$911 million deficit for the rest of the fiscal year after April 20, 2001. When this amount is added to the \$271 million deficit incurred in the first part of the fiscal year, the Service would lose nearly \$1.2 billion in fiscal year 2001. This amount does not include developments in the rest of the fiscal year that the Service projects will have a negative impact on its net income, which are detailed below.

Expenses for the Rest of Fiscal Year 2001 in Addition to Those Previously Budgeted

The Service currently projects that its expenses for the rest of fiscal year 2001 will be \$120 million greater than budgeted, including the following:

- *Transportation and energy expenses:* The Service continues to expect transportation and energy expenses to exceed budgeted amounts for the rest of the fiscal year due to rising prices and cost passthroughs from contractors. Postal officials are concerned that fuel and energy prices may increase substantially in the near future, which also may increase inflation and future cost of living adjustment payments to Service employees and retirees. In addition, unbudgeted transportation-related costs will be incurred for start-up costs associated with the Service's new multiyear contract with FedEx to transport Priority Mail and Express Mail.
- *Other expenses:* Workers' compensation expenses are projected to be about \$50 million over budget for the rest of fiscal year 2001, according to the Service, and to reach about \$1 billion for the full fiscal year. The Service also expects a small impact to result from recent increases in "terminal dues" paid to foreign postal administrations to deliver outbound U.S. international mail that were not factored into the Service's budget.

Revenue Shortfalls for the Rest of Fiscal Year 2001

The Service projects revenues will be below its budgeted targets for the rest of the fiscal year for two reasons. First, the Service budget assumed that it would receive the full rate increase it had requested. However, this did not occur. On January 7, 2001, the Service implemented under protest a smaller-than-requested increase that the Postal Rate Commission had recommended (including a 1-cent increase in the basic First-Class stamp rate to 34 cents). The Service subsequently decided to override the Commission's recommendation on May 7, 2001, and raise rates again on July 1, 2001, to generate the revenues it had originally requested (leaving the First-Class stamp rate at 34 cents). Thus, the Service projects that revenues for fiscal year 2001 will be \$390 million below what its budget had assumed—\$235 million, as a result of the shortfall, through April 20 and \$155 million, as a result of the projected shortfall, for the rest of the fiscal year.

Second, the Service projects that from April 21 through the end of the fiscal year, its revenues will fall below budgeted targets by \$150 million to \$950 million due to the soft economy and its impact on postal revenues. This range reflects the Service's uncertainty about the length and severity of the economic slowdown.

Other Factors May Add to the Service's Deficit for Fiscal Year 2001

The Service's revenues will likely be lower than budgeted targets for the rest of the fiscal year and its expenses will likely be higher than budgeted targets for a variety of reasons:

- The Service is unlikely to achieve its ambitious \$289 million revenue target for the full fiscal year for revenues from e-commerce, advertising, and retail initiatives, given that these initiatives generated only \$2 million in fiscal year 2001 through April 20 – a shortfall of \$138 million from the Service's budget target for this period. In addition, the Service may not achieve its \$454 million target for other miscellaneous revenues, given that these revenues fell \$90 million short of the budget target for the first part of the fiscal year. The Service's historical difficulty in making profits from its new products and services suggests the Board of Governors may wish to look at the Service's policies and practices for determining when the Service should enter into new ventures and when such ventures should be discontinued.³
- Although the Service reports that compensation expenses have been below budgeted targets in recent weeks and that it imposed a hiring freeze on all headquarters positions in April, it is still unclear whether the Service's compensation expenses will achieve the budgeted target for the full fiscal year because these expenses were \$132 million over budget for the fiscal year through April 20.
- The Service may incur additional expenses depending on the outcome of ongoing litigation regarding its previous contracts with Emery Worldwide Airlines Inc., which sorted and transported Priority Mail until early 2001.
- The Service will also need to continue to control expenses such as those for supplies and services so that below-budget expenses for the first part of the fiscal year are not simply deferred to a later time.

Additional Information Could Help Explain the Service's Changing Financial Outlook

The Service has made numerous revisions to its estimated net income for fiscal year 2001 with little or no public explanation, creating confusion and raising concerns about its ability to generate timely and reliable financial information. The significant shift in the Postal Service's financial outlook in early 2001 came as a surprise to a variety of key stakeholders, with many concerns raised after the Service revised its estimated net income for fiscal year 2001 from a \$480 million deficit last November to a \$2 billion to \$3 billion deficit this February. Currently, the Service estimates a \$1.6 billion to \$2.4 billion deficit for fiscal year 2001 (see table 1).

³ U.S. Postal Service: *Development and Inventory of New Products* (GAO/GGD-99-15, Nov. 24, 1998; and U.S. Postal Service: *Postal Activities and Laws Related to Electronic Commerce* (GAO/GGD-00-188, Sept. 7, 2000).

Table 1: Postal Service Estimated Net Income for Fiscal Year 2001

Date	USPS Estimate of Net Income for Fiscal Year 2001	Source
1/12/00 – USPS requests rate increase.		
2/8/00	\$500 million surplus	USPS preliminary performance plan for FY 2001
9/30/00	\$150 million surplus	USPS 5-Year Strategic Plan for FY 2001-2005
10/6/00	\$480 million deficit	USPS final performance plan for FY 2001
11/13/00 – Postal Rate Commission recommends lower-than-requested rates.		
11/14/00	\$480 million deficit	USPS-approved budget for FY 2001
12/4/00	\$960 million deficit	Postmaster General (Federal Times)
12/4/00 – USPS states it will implement Commission-recommended rates under protest.		
12/18/00	\$1.3 billion deficit	USPS Chief Financial Officer
1/7/01 – Higher rates go into effect.		
2/7/01	\$2-\$3 billion deficit	USPS revised budget submission to OMB for FY 2001
5/7/01	\$1.6-\$2.4 billion deficit	USPS estimate provided to GAO
5/7/01 – USPS Board of Governors overrules the Commission; most rates will increase again on July 1, 2001, to generate the revenues USPS originally requested. (The basic First-Class stamp rate remains at 34 cents.)		

Source: U.S. Postal Service and Federal Times.

Postal stakeholders have raised concerns about the reliability of the Service's estimates of its net income for fiscal year 2001. In addition, some stakeholders have said that they do not understand how the Service's financial outlook rapidly worsened to such a great extent from last fall to early this year. To further better understanding, the Service should provide more complete and readily accessible information to Congress and the public on changes in its financial outlook. For example:

- Last fall, the Service did not publicly explain why its published estimates of net income for fiscal year 2001 changed by \$630 million over a 1-week period. Specifically, the Service revised its estimate of net income for fiscal year 2001 from a \$150 million surplus in its 5-Year Strategic Plan dated September 30, 2000, to a \$480 million deficit in the Service's final annual performance plan for fiscal year 2001 dated October 6, 2000. The final plan did not explain why the Service's financial outlook changed over this period. Service officials told us that the change was due to its decision to lower estimated revenues for fiscal year 2001.
- Further, although Service officials have provided explanations of changes in the Service's financial outlook in open forums—such as monthly Board of Governor's meetings, meetings with mailer groups, and in testimony before Congress—these explanations have not been as readily accessible to those not in attendance.

Greater transparency is needed in connection with the Service's financial and operating results and projections. To this end, in April 2001, we recommended that the Service provide summary financial reports to Congress and the public on a quarterly basis. These reports should present sufficiently detailed information for stakeholders to understand the Service's current and projected financial condition; how its outlook may have changed since the previous quarter; and its progress toward achieving the desired results specified in its comprehensive plan to address its financial, operational, and human capital challenges. Service officials told us that they generally agree with our

recommendation and are considering how to best implement it. On May 11, 2001, the Deputy Postmaster General, the Chief Financial Officer, and I met to discuss how to proceed in this area. As we discussed in that meeting, one way the Service could achieve greater transparency would be to post this information on its Web site to facilitate timely communication of the information.

The Service's Financial Outlook for Fiscal Year 2002

The Service currently estimates that its deficit for fiscal year 2002 will be \$1.5 billion to \$2.5 billion. This range is about \$1 billion less than the Service projected earlier this year because the Service has decided to implement higher rates for most categories of mail on July 1, 2001. Many uncertainties exist that could affect the Service's net income for fiscal year 2002. For example, the estimated deficit for fiscal year 2002 assumes no further increases to postal rates in fiscal year 2002. However, the Service's Board of Governors directed postal management to prepare a request for another rate increase. If the Service seeks another rate increase to be implemented during fiscal year 2002, its deficit projection could change.

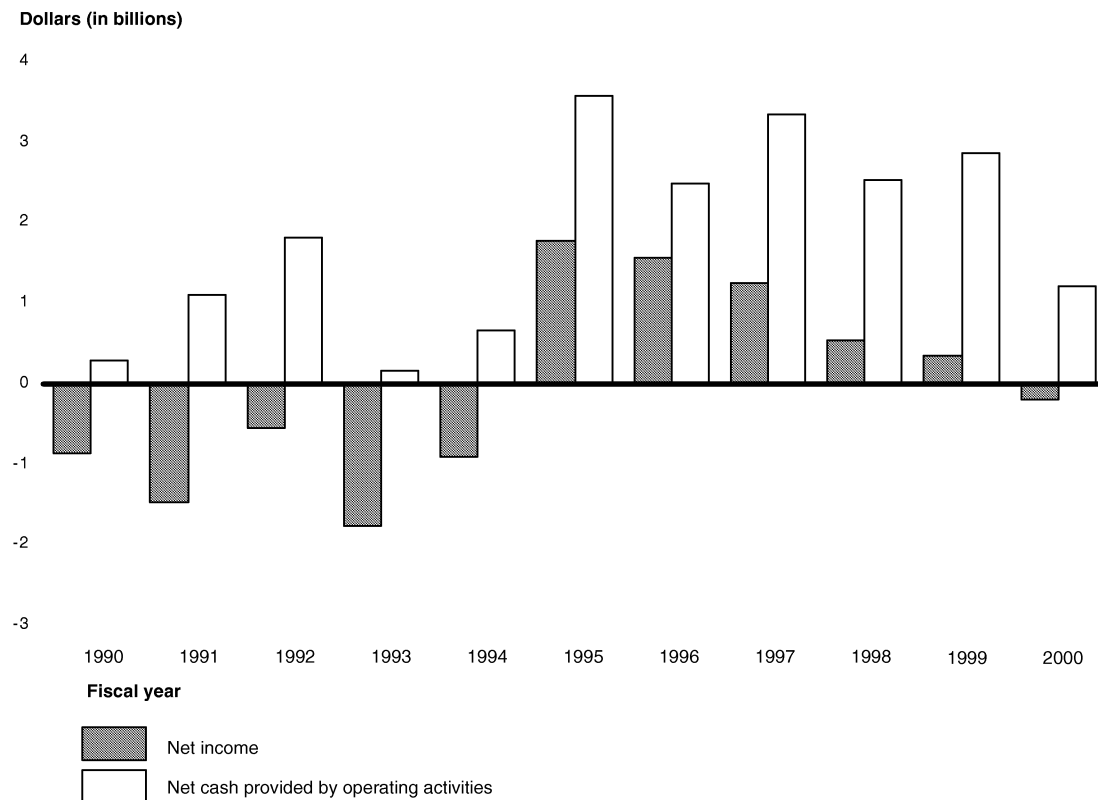
The Service Has Growing Cash Flow and Debt Challenges

The Service's declining net income and current losses are putting pressures on its cash flows from operations (the funds that remain after the Service pays its expenses) and debt situation. The Service has been generating less cash flow from operations that are used for capital expenditures and debt repayment. Therefore, the Service has relied increasingly upon debt to finance its capital expenditures and expects to reach its \$15 billion statutory debt limit by the end of fiscal year 2003, assuming no further increases in postal rates after July 1, 2001. Under this scenario, the Service could pay bills only through its cash on hand plus additional cash generated from operations until outstanding debt declines.

As shown in figure 6, the Service's cash flows from operations are typically significantly greater than its net income. The primary reason for the difference is that net income is calculated on the accrual basis of accounting⁴ and includes accrued expenses, such as depreciation expense, that do not use cash.

⁴ Under the accrual basis of accounting, revenues are recorded when earned, and expenses are recorded when incurred, even if these activities are not concurrent with the related receipt or outlay of cash.

Figure 6: Postal Service Net Income and Cash Flows From Operations



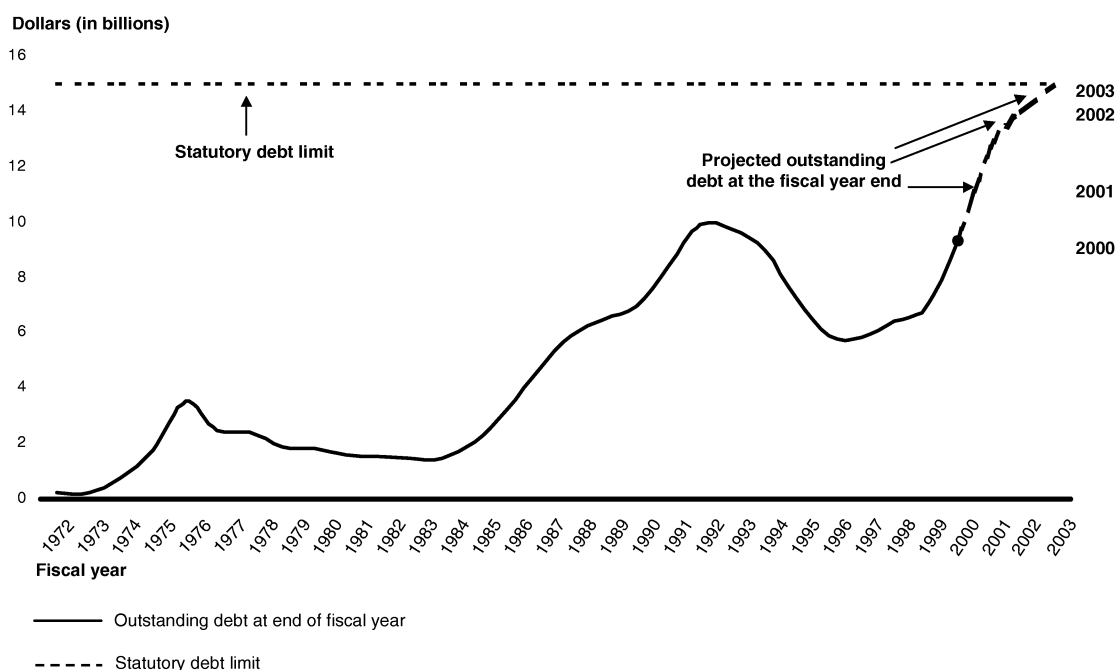
Source: U.S. Postal Service.

The Service is currently experiencing some cash flow pressure because of its deficits, but it anticipates it will make all of its fiscal year 2001 year-end payments for retirement expenses and worker's compensation. To avoid a cash shortage during fiscal year 2001, the Service has placed a freeze on capital commitments that will affect more than 800 facility projects this year. Last year the Service had planned capital commitments of \$3.6 billion for fiscal year 2001, but Service officials recently announced reductions in this area and told us they now anticipate a reduction to about \$1.7 billion in capital commitments this fiscal year. Preliminary budget plans for fiscal year 2002 would reduce capital investment from originally planned levels. To the extent that a freeze on needed capital investments is required to conserve cash, it may simply change the timing of such expenses and raise the final cost, while deferring any related expected benefits.

The Service has mounting debt and many billions of dollars in liabilities for future retirement and worker's compensation expenses. These liabilities have increased in part because the Service was statutorily mandated to assume responsibility for funding all cost of living adjustments and health benefits for its retirees since July 1, 1971. For the remainder of this decade, these liabilities will continue to have an increasing impact on the Service's future cash flows, placing the Service under growing financial pressure.

The amount that the Service borrows on an annual basis is largely determined by the difference between its cash flows from operations and the amount it spends on its capital investments. The Service has experienced a net increase in outstanding debt at the end of each fiscal year since 1997; and beginning in 1998, the Service's cash outlays for capital expenditures exceeded its cash flows from operations. The Service's debt increased from \$5.9 billion at the end of fiscal year 1997 to \$9.3 billion at September 30, 2000. The Service has an annual limit of increasing its outstanding obligations by \$3 billion (that includes a \$2 billion limit for capital improvements and a \$1 billion limit to defray operating expenses). Assuming that the Service's latest financial outlook is on target, the Service would reach its \$15 billion statutory borrowing limit by September 30, 2003 (see fig. 7).

Figure 7: Trends in Postal Service Debt

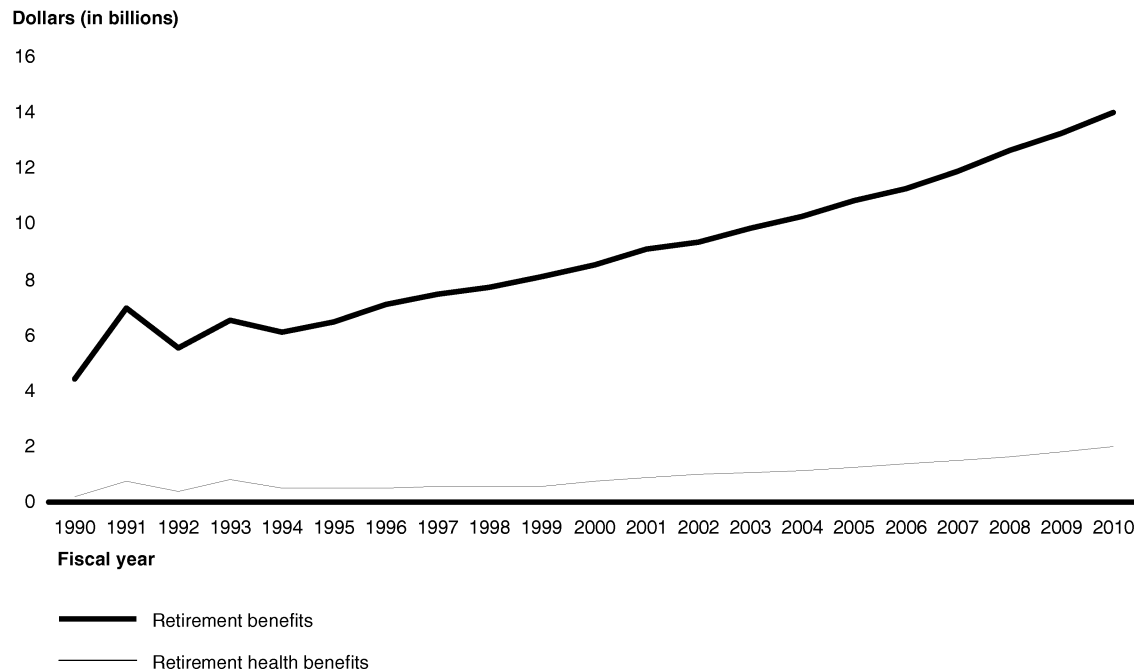


Source: U.S. Postal Service.

Growing Retirement Expenses

The Postal Service's retirement-related expenses have increased in recent years, and these trends are expected to continue (see fig. 8). The Service's retirement liabilities translate into annual payments from the Service to the federal government's Office of Personnel Management, which administers payments to retirees. The Service has been making these payments at the end of each fiscal year. According to the Service, these payments are estimated to increase by \$554 million in fiscal year 2001 to \$9.1 billion and are projected to reach \$14.0 billion in fiscal year 2010. In addition, the Service has estimated that its retiree health benefit premium expenses will increase by \$114 million in fiscal year 2001 to \$858 million, and the Service has projected that these expenses will reach about \$2.0 billion in fiscal year 2010.

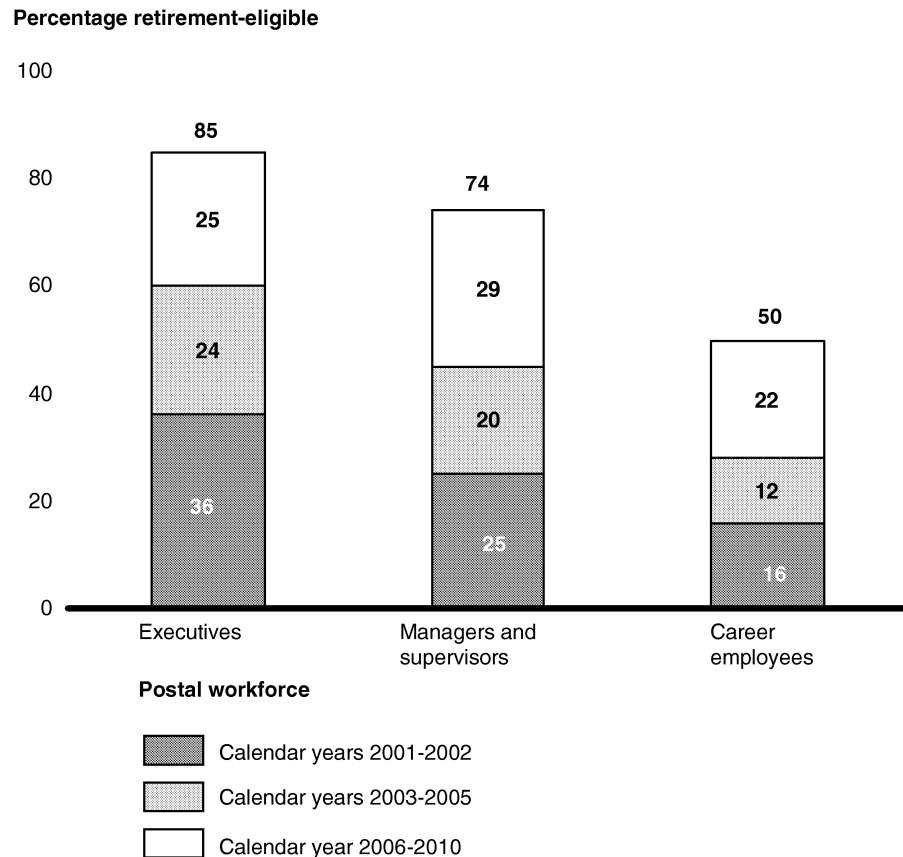
Figure 8: Postal Service Projects Increases in Retirement-Related Expenses



Source: U.S. Postal Service.

The Service has projected that among its current employees as of October 2000, about 130,000 postal employees were already eligible, or will reach eligibility, for regular retirement in calendar years 2001 and 2002. This projection includes 36 percent of executives, 25 percent of managers and supervisors, and 16 percent of the career workforce. By calendar year 2010, 85 percent of postal executives, 74 percent of postal managers and supervisors, and 50 percent of the career workforce will reach retirement eligibility, according to Service projections (see fig. 9). Although many employees do not retire immediately, the increasing number of postal employees who will become eligible to retire in the remainder of this decade raises questions about succession and workforce planning. If retirees are not replaced with the appropriate number of employees possessing the needed skills, the resulting loss of institutional knowledge and expertise may affect mission achievement.

Figure 9: A Large Percentage of the Postal Workforce Is Nearing Retirement



Source: U.S. Postal Service.

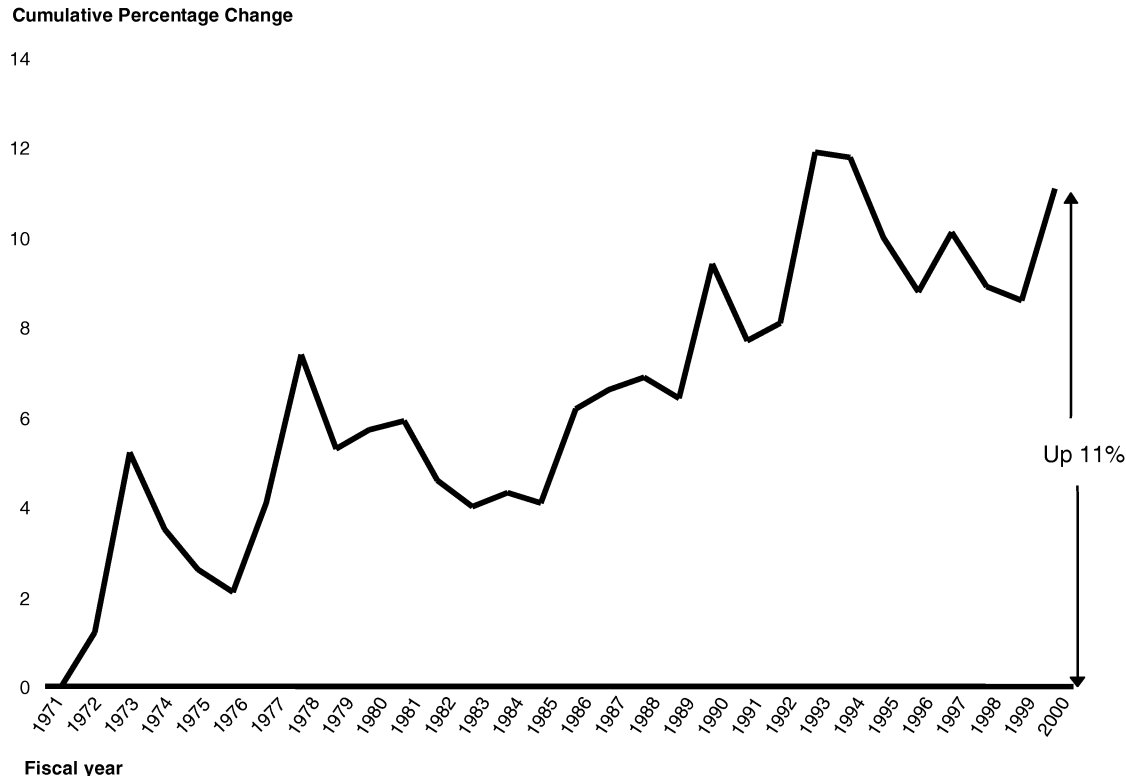
The Service has reported unfunded Civil Service Retirement System retirement liabilities of \$32.2 billion at September 30, 2000. These liabilities represent the amount due to the Office of Personnel Management to cover Civil Service Retirement System pay increases and Civil Service Retirement System retirees' cost of living adjustments. The Service also has related future interest payments estimated at \$16.5 billion. These liabilities are being paid through annual installments. In fiscal year 2000, the Service paid \$3.6 billion toward its liability to the Office of Personnel Management for these Civil Service Retirement System costs. The Service's total annual retirement expenses for both the Civil Service Retirement System and the Federal Employees Retirement System is projected to be \$9.1 billion for fiscal year 2001. The Service projects its total retirement expenses will increase annually to \$14 billion in fiscal year 2010. These increased payments could reduce the Service's cash flows and place upward pressures on postal rates.

What Actions Has the Service Taken or Planned to Address Its Financial Problems?

We believe that the Service's deteriorating financial situation calls for prompt, aggressive action, particularly in the areas of cutting costs and improving productivity in the near term. The Service has initiated efforts in this regard and has also launched new products and services to increase revenues. However, we believe that it will be difficult for the Service to generate significant revenues from new products and services in the next few years. To the extent that operating costs are not contained or reduced, or revenues are not generated from new products and services, the Service will likely need to continually raise rates to maintain service and to meet its break-even mandate, at least in the short term. However, simply raising rates is not the answer. The Service and the Congress must take actions in order to deal with the systemic problems facing the Service.

Postal productivity—the relationship between the Service's outputs of delivering mail to an expanding delivery network and resources expended in producing them—increased only about 11 percent in the past 3 decades, despite vast changes in automation and information technology (see fig. 10). Although the Service achieved a 2.5 percent increase in its productivity in fiscal year 2000, as the Postal Service and key stakeholders have recognized, sustained long-term increases in its productivity will be essential to controlling costs and thus keeping postage rates affordable. However, numerous reports, including some by us and the Postal Service's Inspector General, have noted inefficiencies in the postal system and difficulties the Service has had in realizing opportunities for savings over the long term.

Figure 10: Postal Service Productivity Growth Since Fiscal Year 1971



Source: U.S. Postal Service.

The Service's ability to improve productivity and control costs is constrained by a number of factors, such as its mandate to provide postal services to all communities. In addition, the Service has had difficulty in achieving the expected savings from implementing new technology. The Service has also reported that extensive work rules and other regulations hamper its flexibility and innovation; and by law, wages and work rules are determined by binding arbitration—a third-party panel—when the Service and its labor unions cannot reach agreement. This process has been criticized as lessening the incentives for both sides to reach agreement. However, no consensus exists on alternatives to this process.

The Service has a self-imposed moratorium on closing post offices. By law, the Service cannot close small post offices solely for operating at a deficit. Further, fiscal year 2001 appropriation legislation restricts the Service from closing small or rural post offices in fiscal year 2001, and this provision has been included in the Service's appropriation legislation for many years. The Service estimated several years ago that about half of all post offices do not generate sufficient revenues to cover their costs. However, the law also provides that the Service in determining whether to close or consolidate post offices must consider the effects on the local community, employees at the post offices, provision of universal service, the resulting savings, and other factors that the Service determines are necessary. Furthermore, the Service has a long, complex, detailed

process for closing post offices in cases such as consolidating multiple post offices in substandard buildings that are located in an area with significant population loss.

Breakthrough Productivity Initiatives

The Service recognizes that it needs aggressive cost management. In March 2000, the Postmaster General called for achieving “breakthrough” productivity savings of \$1 billion annually, mainly in mail processing, transportation, and administrative areas. The Service’s fiscal year 2001 budget called for saving \$550 million through such productivity initiatives and \$450 million in additional savings from other cost reduction initiatives. The Service set a goal of increasing its productivity by 0.7 percent for fiscal year 2001 and reports that its productivity increased 1.9 percent for fiscal year 2001 through April 20, which equates to reduced expenses of \$775 million. At the same time, given past experience, the Service faces a significant challenge to achieve and sustain large increases in productivity over the long term. Looking ahead, the Deputy Postmaster General announced that the Service is committed to cutting costs by \$2.5 billion by 2003. Also, he said that over the next 5 years the Service plans to cut 75,000 work years, reduce administrative costs by 25 percent, and cut transportation costs by 10 percent.

The Service defines breakthrough productivity as a systemic focus on improving productivity by “reducing costs through everything from machine utilization, to standardized processes, to staffing and scheduling, and to resource management.” The breakthrough productivity initiatives fall into four key areas: (1) operations, (2) administration, (3) purchasing, and (4) transportation.

- *Operations:* According to the Service, savings in operations will be achieved by implementing best practices on a nationwide basis in areas with the greatest potential for savings, such as using standardized operating procedures and adjusting employees’ work schedules to more closely coincide with mail volume. Further savings are to be achieved by accelerating the automation program, which is to reduce the need for manual sorting of mail.
- *Administration:* Administrative positions are to be reduced by centralizing functions, using electronic technology, and eliminating unnecessary administrative transactions. For example, the Service is replacing its outdated time and attendance reporting system with a Web-based application requiring much less time to administer.
- *Purchasing:* The Service plans to cut the cost of purchased goods and services by standardizing purchasing sources and leveraging the Service’s size to obtain better prices.
- *Transportation:* The Service reports making across-the-board efforts to reduce the cost of transporting mail at all points in the system, largely by reviewing all mail transportation contracts to identify and eliminate underused and redundant service. These reviews are nearly complete. The Service has reported that it expects considerable savings from moving mail by truck instead of by air due to lower rates.

Other Cost Reduction Programs

In addition to the Service's "breakthrough" productivity initiatives, the Service has announced that it plans to achieve \$450 million in savings through other automation initiatives, including the following:

- Upgrading letter-sorting equipment: The Service continues to upgrade this equipment with enhanced optical character reading, barcode sorting, and remote encoding functions.
- Adding and upgrading equipment to sort flat mail such as catalogs and periodicals: New equipment is being deployed to replace some older models and handle additional capacity, and some current models are being equipped with automatic feeders and optical character readers.
- Adding and upgrading material-handling equipment: Robots are being deployed to load mail containers for dispatch, enhancing equipment that transports and stages mail in processing plants, and deploying new technology to dispatch and route mail transported on commercial air carriers.

What Transformational Issues Will Need to Be Addressed?

In addition to the financial and operational issues discussed above, over the past 2 years we have raised concerns about a range of human capital challenges that threaten the Postal Service's ability to continue to provide affordable, high-quality universal postal service on a self-financing basis. We have also discussed the constraints facing the Service, some of which include legal and regulatory requirements, that may impede its ability to carry out its mission. The 30-year-old legal and regulatory system established by the nation's postal laws is increasingly problematic for both the Service and its competitors and is overdue for change. When the Service was created as an independent establishment of the executive branch by the Postal Reorganization Act of 1970, it faced little direct competition. Today, the Service faces growing competition from both private delivery companies and the Internet, and even foreign postal administrations.

In this vastly changed environment, the Service is subject to several statutory and regulatory restrictions that limit its transformational efforts and do not apply to its competitors (e.g., universal postal service requirement, binding arbitration requirement, rate-setting process, and facility closure restrictions). At the same time, the Service has a statutory postal monopoly to deliver letter mail, and also benefits from laws that apply to the Service differently than they apply to its competitors, such as not paying taxes and not being subject to antitrust laws. Congress needs to revisit what statutory and regulatory framework would be appropriate for the Service in the 21st century.

Financial Challenges

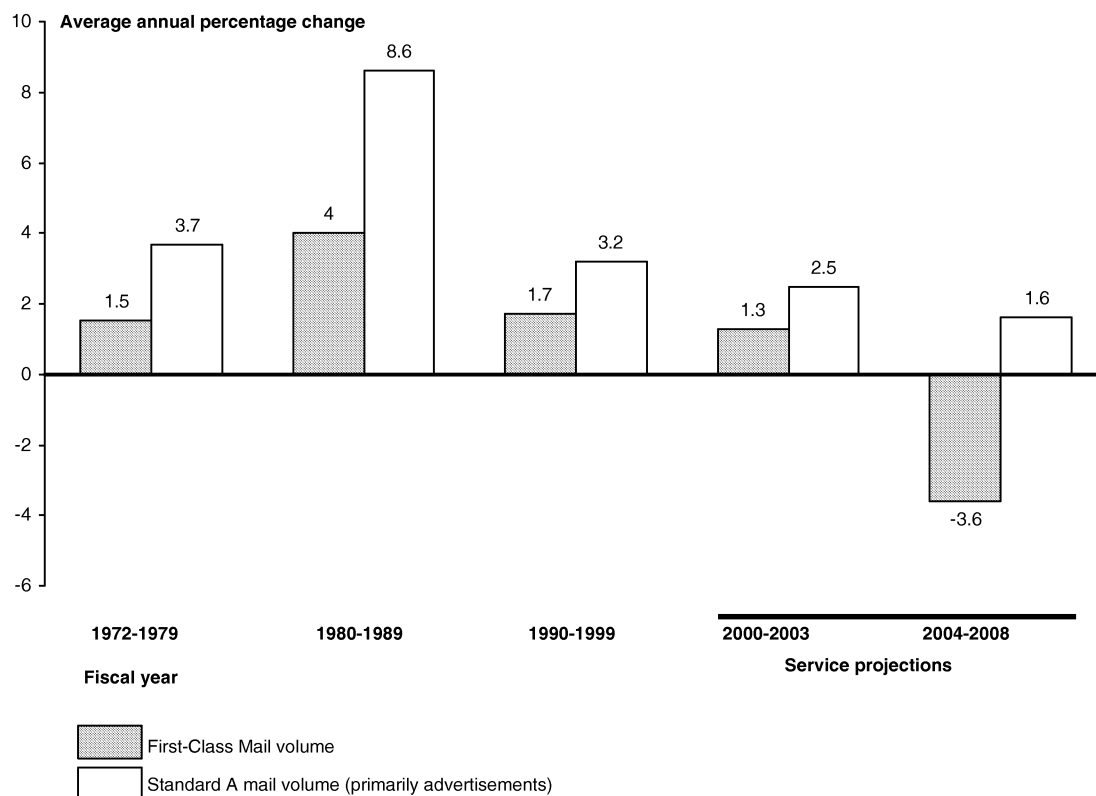
Changes in the marketplace, including greater competition, may lead to increasing financial difficulties for the Service and threaten its ability to provide universal postal service at reasonable rates while remaining self-supporting from postal revenues.

Recently, the Service initiated a study to determine the potential cost savings from reducing mail delivery from 6 to 5 days each week. Can the Postal Service continue to maintain the scope and quality of its retail and delivery services? The answer, at least in the short term, is “yes” – but in the long term, the Service’s prospects are uncertain.

Competition is already increasing from private delivery companies and foreign postal administrations accepting outbound international mail from within the United States. For example, United Parcel Service (UPS) is offering a hybrid mail service in which letters are electronically sent to a recently acquired UPS company and then printed and inserted into the U.S. postal system. In addition, at least eight foreign postal administrations now offer services from within the United States to American consumers.

Although it is difficult to predict the timing, magnitude, and potential financial impact of further mail volume diversion to other competitors and to electronic alternatives, according to the Service’s latest 5-Year Strategic Plan, longer-term projections suggest that about half of mailed bills and payments will eventually be replaced with electronic billing and payment alternatives. Thus, under the Service’s baseline forecast that is included in its 5-Year Strategic Plan, First-Class Mail volume would decline at an average annual rate of 3.6 percent from fiscal years 2004 through 2008 (see fig. 11).

Figure 11: Postal Service Projects Decline in First-Class Mail Volume



Source: U. S. Postal Service.

If First-Class Mail volume declines and the revenue loss is not offset by increasing mail volume in other areas, such as advertising mail or by revenues from new initiatives such as e-commerce, rates would need to rise for any mail categories that take on a larger burden of supporting postal overhead costs. The Service would also face the challenge of responding to any volume declines or changes in the mail mix by attempting to reduce mail processing, personnel, and other costs that have traditionally been considered to vary with changes in the mail volume. However, these costs may be difficult to adjust in the short term. Adding to rate pressure, postal infrastructure costs continue to grow. The Service maintains a delivery and retail network that includes more than 235,000 city and rural delivery routes; more than 38,000 post offices, stations, and branches; and more than 350 major mail processing and distribution facilities. Each year the Service adds new delivery points for new households and businesses—a projected 1.8 million in fiscal year 2001.

Human Capital Challenges

The Postal Service faces additional difficult human capital challenges that must be successfully addressed to maintain organizational effectiveness and improve the workplace environment as well as control workforce costs. These challenges include (1) restructuring the postal workforce of about 900,000 career and non-career employees

and establishing succession planning for impending retirements; and (2) ameliorating the persistent problems in the workplace that have been exacerbated by decades of adversarial labor-management relations and that hinder efforts to improve productivity. The Postal Service's human capital problems can be seen as part of a broader pattern of human capital shortcomings that have contributed to programmatic problems and risks across the federal government.

The Service's Strategic Plan stated that the expected decline in postal workload—in part due to automation and the implementation of information technology—“will inevitably result in both restructuring and a reduction in the workforce.” Some of the planned reductions are to be accomplished through eliminating staff vacancies and the work associated with them. These reductions should be done in a carefully planned manner to avoid negatively affecting the workplace environment, operations, and service quality. The Service will be increasingly challenged to deal with human capital issues related to succession planning, maintaining continuity, and the associated cost issues. With a large percentage of the postal workforce nearing retirement eligibility, the Postal Service has the opportunity to realign its workforce and assure that it has the leadership, knowledge, and skills necessary to efficiently and effectively carry out its mission. Given the nature of these issues, the Service will need to include effective participation of its employees in planning and implementing workplace improvements. The Service will also need to maintain the continuity of service to customers as many experienced managers and workers retire and the Service restructures its workforce.

Fundamental improvement is needed in postal labor-management relations. The Service and its major unions and management associations need to resolve long-standing labor-management problems that have hindered improvement efforts, including efforts to cut costs and increase productivity. For example, the Service has made progress in reducing the number of grievances, but at the end of fiscal year 2000, the Service reported about 147,000 pending or appealed grievances. For the Service to be successful, it is critical that it achieves and sustains collaborative working relationships with its labor unions and management associations.

Transformation Questions

If the Postal Service is to transform itself into a modern, efficient, high-performance organization that continues to provide affordable, universal postal service in the 21st century, the starting point is to define and clarify the Service's mission and role over the long term. The Service needs to address questions about its basic mission—that is, the type of postal services that should be provided on a universal basis to meet business and residential customer needs, how these services should be provided, and how they should be financed. Further, questions arise related to what kind of governance and regulatory framework is needed to ensure public accountability. Some of the specific questions that need to be addressed as part of the structural transformation include the following:

- What is the appropriate mission and role of the Postal Service in the 21st century? How should “universal postal service” be defined? How should universal postal

service obligations be provided? Should the postal monopoly be narrowed or ended? Should the Postal Service be allowed to compete in areas served by the private sector and, if so, under what circumstances? To what extent should the Service be subject to the same laws as its competitors?

- Can the Postal Service remain self-supporting under a break-even mandate? If not, what types of financing options should be considered? Should the Service be allowed to make a profit? Should universal postal services be subsidized?
- What changes to the governance and organization structure are needed to realign the organization so that it can successfully achieve its mission? What type of governing board is appropriate? What should be its role? What criteria would be appropriate for selecting board members?
- What should be the related regulatory framework providing oversight in the areas of rate setting, new postal products, and fair competition? How much flexibility should the Service have to change rates? What oversight is needed to protect customers with few or no alternatives to the mail? How should the Postal Rate Commission and other pertinent regulatory authorities exercise oversight with respect to competition and antitrust issues?
- How is the Service to use its employees to accomplish its mission in an efficient, effective, and economic manner? What are the Service's current and future human capital needs? How will the Service ensure that it has the knowledge, skills, and the abilities that are needed? How will the Service make the necessary changes to its workforce, including its size, organization, and deployment?
- What performance management and incentive systems are needed to improve individual and team performance? How can the Service ensure that its managers and supervisors are prepared and trained to provide effective leadership? What labor policies are needed? How can the Service's management and postal unions and management associations develop a shared understanding of the Service's vision; undertake a mutual effort to achieve it; and resolve problems and conflicts over wages, work rules, and individual cases in a fair and effective manner?
- What operational changes are needed to support the Service's mission? How can technology help the Service improve productivity, reduce costs, and enhance customer service?
- Are fundamental changes needed in how the major functional areas are carried out—mail collection, transportation and mail processing, delivery, and retail services? Is the Service's current physical infrastructure aligned to efficiently and effectively support operations? What types of and how many facilities are needed? Should certain existing facilities be consolidated or eliminated? Should certain functions be contracted out or addressed via public/private partnerships?

- What performance and cost information is needed and collected to support Service operations and measure results? What information on projected and actual performance should be periodically reported to the public? How well integrated are the Service's financial, management, and performance reporting systems?

In addition, several issues need to be addressed related to how the Service should be held accountable for results. We have reported that the Postal Service's annual performance plans and its first performance report under the Government Performance and Results Act of 1993 have not been as useful to Congress, postal managers, and customers as they could have been. In our view, the Service's recently published preliminary performance plan for fiscal year 2002 did not fully address the concerns we previously raised about the Service's approach to setting goals and reporting on results. For example, the preliminary plan dropped important goals for net income and for the timely delivery of 2- and 3-day First-Class Mail.

Also, a number of issues have been raised related to the reliability and credibility of the data the Service uses for ratemaking. Timely, accurate, and relevant information will be critical for effective management as well as communications with customers, Congress, and other stakeholders.

Engagement with Postal Stakeholders

Engaging with stakeholders will be an essential part of developing a consensus to address the Service's transformational issues. When the Service begins to engage with its stakeholders to develop a comprehensive transformation plan, it will face a stakeholder community far from consensus on what needs to be done. It would be useful for the Service to develop an approach for engaging with its stakeholders in the development of its comprehensive plan.

In response to the joint request to us from this Committee and Subcommittee, we are working to identify improvement options suggested by various stakeholders and will summarize the results in our subsequent report to you. We have begun this effort and have talked to several stakeholders and plan to continue these discussions. Some of the stakeholders we have talked to so far have included postal unions, mailer groups, competitors, the Service's Office of Inspector General, and Postal Rate Commission officials. They provided a variety of suggestions for action, some within the existing legal framework and others that would require statutory change, as follows:

- *The Service's mission and role:* Representatives of a mailer group and a Service competitor said that the Service's mission should be more clearly defined and raised the issue of whether the Service should be changed to a stock-owned corporation. In the mailer's view, making the Service a corporation with shareholders would hold it accountable and create incentives for success. In the competitor's view, the Service should either be restricted to offering monopoly services that do not compete with the private sector or be held to the same rules as its competitors.

- *Regulation of postal rates:* A mailer group and a union representative favor statutory changes to give the Service more flexibility to set postal rates. For example, a union representative said that the Service should be able to adjust postal rates in response to economic trends. However, Postal Rate Commission officials and a mailer group representative stated that the Service has the flexibility under current law to request alternative rate structures, such as peak-load pricing and phased rate increases.
- *Transparency and accountability:* Postal Rate Commission officials and mailer group representatives recommended that the Service provide more frequent and complete financial and service quality information to the public. For example, they said the Service should regularly disclose the on-time delivery of different classes of mail so that it can be held accountable for the quality of service it provides.
- *Workplace environment:* Several stakeholders stated that better communication is needed among employees, management, and external stakeholders to improve the atmosphere in the workplace and increase productivity. A postal union representative noted that a different management style is needed to encourage employees to give additional discretionary effort. For example, the representative suggested initiating more “bottom-up” communication from employees.
- *Pay and performance incentives:* Some stakeholders noted that greater incentives are needed to maximize productivity and efficiency. For example, a mailer group representative said that management and employees need more effective incentives to further organizational achievement of goals. On the other hand, union officials said that the existing management bonus system encourages managers to take unwarranted action to receive bonuses. Further, a union official noted that city and rural carriers work side by side in some suburban areas under different pay systems, different ways of setting and adjusting the workload, and different incentives for good performance.
- *Flexible staffing:* A mailer group representative favored greater use of flexible staffing procedures to minimize compensation costs, such as using more noncareer workers to handle peak mail volumes. Union officials expressed a different view, favoring the elimination of noncareer jobs to save money.
- *Retail infrastructure:* Mailer group representatives said that the Service should consider, as part of a package of changes, restructuring the retail network by closing post offices and/or relocating retail operations from some post offices to postal retail operations provided in other locations such as retail stores. For example, a mailer group representative suggested a reevaluation of the statutory restrictions on closing post offices, including a reconsideration of the prohibition against closing post offices solely for operating at a deficit. The mailer group representative suggested that the military base-closing model could be used when evaluating the possibility of closing unprofitable post offices.

- *Mail processing network:* Some stakeholders said that the Service could become more productive by using existing automation equipment more efficiently and continuing automation efforts. A mailer group representative advocated that the Service achieve greater standardization of mail processing operations by adopting best practices throughout the system to the maximum extent possible. A representative of an equipment manufacturer said that the Service needed better long-term planning in this area, as well as working more effectively with its major suppliers.
- *Delivery network:* A mailer representative said the Service could save money if some existing residential customers (e.g., customers with mailboxes attached to their homes) were required to use cluster boxes, thus increasing route efficiency.
- *Worksharing discounts:* A union official stated that worksharing discounts—that is, discounts to mailers for mail preparation such as barcoding, presorting, and dropshipping mail—should be greatly reduced or eliminated. In the union official’s view, the Service could improve its net revenue by doing the worksharing functions in-house at less cost. In contrast, a mailer group representative said more worksharing incentives are needed for the Service to process mail efficiently, save money, and encourage growth in mail volume. Further, Postal Rate Commission officials said that the Service has the ability under current law to request additional types of worksharing discounts.
- *Productivity initiatives:* A mailer group representative stressed the importance of the Service improving its productivity through cost cutting. For example, he said that the legislatively established rate-setting process provides little incentive for innovation and efficiency since the Service can cover its costs by increasing postal rates. Union officials said that unions and employees could contribute toward developing initiatives to improve the Service’s productivity if there was greater prior consultation. At the same time, however, one union official described the Service’s current productivity initiatives as harassment of employees.
- *Administrative improvements:* The recent statement of the Service’s Inspector General before the House Committee on Government Reform suggested a number of actions the Service could take to improve its performance, accountability, and financial position. One area cited where additional efficiencies could be improved was in the Service’s contract management practices. For example, one Inspector General investigation reported that the Service paid over \$800,000 for asbestos abatement work that was either over-billed or not performed. The report suggested that the Service needed to strengthen its quality assurance procedures and training of Service contracting officials to ensure accurate contractor billings.
- *New products:* Some stakeholders have said that the Service should have a more business-like approach to its new product initiatives so that the Service would stop spending money on projects that are not generating a positive return.

- *Debt limit:* A mailer group representative and a union official favored raising the statutory debt limit to give the Service the flexibility to borrow instead of raising rates.

Mr. Chairman, that concludes my prepared statement. I would be pleased to respond to any questions that you or the Members of the Committee and Subcommittee may have.

Contact and Acknowledgments

For further information regarding this testimony, please contact Bernard L. Ungar, Director, Physical Infrastructure Issues, on (202) 512-8387. Individuals making key contributions to this testimony included John H. Anderson Jr., Teresa L. Anderson, Hazel J. Bailey, Gerald P. Barnes, Joshua M. Bartzen, William J. Doherty, Michael J. Fischetti, Jeanette M. Franzel, Kenneth E. John, Roger L. Lively, Albert E. Schmidt, and Charles F. Wicker.

**LETTER SENT TO POSTMASTER GENERAL,
JOHN E. POTTER, JUNE 14, 2001
FROM SENATORS LIEBERMAN, THOMPSON, AKAKA, AND COCHRAN**

United States Senate
WASHINGTON, DC 20510

June 14, 2001

The Honorable John E. Potter
Postmaster General
United States Postal Service
475 L'Enfant Plaza, SW
Washington, DC 20260-1000

Dear Postmaster General Potter:

We share your concerns about the current financial difficulties and the future of the U.S. Postal Service. We agree that fundamental change is needed, but it must be made in a comprehensive manner that includes input from postal management, employee unions and associations, and other stakeholders, and addresses the underlying weaknesses in the current system.

At the joint hearing we held on May 15, the Comptroller General testified that the Service faces many challenges that call for a structural transformation if the Service is to remain viable in the 21st Century. He emphasized that incremental rate increases alone would not solve the Service's fundamental financial problems. GAO has placed the Postal Service's transformation on its High-Risk List and called for the Service to develop a comprehensive transformation plan that would identify the structural changes needed to address its short-term and long-term financial, operational, and human capital challenges. GAO also called for the Service to provide summary financial reports on a quarterly basis so that all postal stakeholders would have a better understanding of the Service's financial situation.

We endorse the GAO's recommendations and believe it is critical that a comprehensive plan and quarterly financial reports be developed. We request that you provide us with this comprehensive transformation plan by the end of this year. We also endorse the suggestion of the Comptroller General that this plan should analyze several options. GAO's testimony laid out many of the key questions that need to be addressed as part of the transformation assessment.

Further, we think the Service needs to address another key financial issue--how it plans to reduce its mounting outstanding debt. We understand that the Service may reach its statutory debt limit by the end of fiscal year 2003, and we believe that a plan to address this potential financial crisis is needed as soon as possible.

The Honorable John E. Potter
June 14, 2001
Page 2

We want to continue working with the Postal Service, GAO, and other stakeholders in developing improvements that will provide better postal services for the American people. Thus, we plan continued oversight of the Service's financial situation and its plans for a comprehensive transformation of the Postal Service that will better position the organization to meet America's postal service needs for the 21st Century.

Sincerely,



Joseph I. Lieberman
Chairman
Committee on Governmental
Affairs



Fred Thompson
Ranking Member
Committee on Governmental
Affairs



Daniel K. Akaka
Chairman
Subcommittee on International
Security, Proliferation and
Federal Services



Thad Cochran
Ranking Member
Subcommittee on International
Security, Proliferation and
Federal Services

TC:acf

**POSTMASTER GENERAL JOHN E. POTTER'S
JUNE 25, 2001 RESPONSE TO CONGRESS FOLLOWING SENATE
LETTER OF JUNE 14, 2001**



June 25, 2001

Honorable Fred Thompson
Ranking Minority Member
Committee on Governmental Affairs
United States Senate
Washington, DC 20510-6250

Dear Senator Thompson:

On April 24, 2001, Mr. Bernard Ungar, director, Physical Infrastructure Issues, of the General Accounting Office (GAO), wrote to former Postmaster General William J. Henderson. As provided by 31 U.S.C. 720, the head of a federal agency is required to submit a written statement to the oversight committees on actions taken on recommendations from the GAO. This letter fulfills that requirement and responds to your June 14 follow-up letter regarding GAO's recommendations.

Comptroller General David Walker testified before the House Committee on Government Reform on April 4. Two recommendations were made at that time (as summarized in Mr. Ungar's April 24 letter):

- (1) "The Service should provide summary financial reports to Congress and the public on a quarterly basis. These reports should present sufficiently detailed information for stakeholders to understand the Service's current and projected financial condition, how its outlook may have changed since the previous quarter, and its progress toward achieving the desired results specified in the comprehensive plan."
- (2) "The Service should develop a comprehensive plan, in conjunction with Congress and other stakeholders, such as the postal unions and management associations, customers, and the Postal Rate Commission, that would identify the actions needed to address the Service's financial, operational, and human capital challenges, and establish a time frame and specify key milestones for achieving positive results."

Since the time of this April 24 letter, my staff has met with the GAO staff on a number of occasions. Deputy Postmaster General and Chief Marketing Officer John Nolan and Chief Financial Officer and Executive Vice President Richard Strasser have met with the comptroller general, and I have spoken with Comptroller General Walker personally. Together we have developed a plan of action that will, we believe, be fully responsive to the GAO's recommendations. Further, we plan to continue to stay in close touch to address the concerns that Comptroller General Walker raised when he noted that the transformation of the Postal Service is at risk.

Financial Reports

With respect to this recommendation, Chief Financial Officer Richard Strasser makes a quarterly presentation of financial results to the Board of Governors at its public meetings. Mr. Strasser has met with the GAO and has discussed methods to provide additional transparency related to its financial condition. A major step in that direction, and in direct response to GAO's recommendation that summary financial reports to Congress and the public be made on a quarterly basis, in the near future we will place our Quarter III Financial Statements, similar to

what publicly traded enterprises provide, on our Web site at www.usps.com. We will continue this practice quarterly, with the audited fiscal year report as the Quarter IV version. Our *FY2000 Annual Report* is also available on the Web site.

Comprehensive Plan for Transformation

In the twenty-first century business environment, for the Postal Service to continue providing the people of the United States affordable, high-quality universal service without relying on taxpayer subsidy, the Postal Service must be transformed to meet a new and rapidly evolving set of financial, operational, and human capital challenges. Over the last five years, the Postal Service, the Congress, and other stakeholders have invested a great deal of thought and effort in developing needed postal reforms. That process continues. In his testimony on April 4, Mr. Walker announced that the GAO has placed the Postal Service's transformational efforts and long-term outlook on its *High-Risk List*. To introduce a new planning framework for public consideration of needed postal reform, the GAO has recommended that the Postal Service work with stakeholders to offer a formal, comprehensive plan for accomplishing transformation. Building and extending from work already completed, such a plan could provide the opportunity for the Congress and the public to evaluate what kinds of postal policies and structures are most appropriate for the twenty-first century. We agree that such a plan is needed and have begun the work of coordinating with affected stakeholders to develop such a plan.

Our *Comprehensive Transformation Plan* will provide a first step in describing our future direction and the pathway to reaching our goals. The *Plan* will in fact consider multiple pathways and include a range of options for both administrative and legislative changes. The *Plan* will discuss the pros and cons of each option and appropriate time frames and milestones for accomplishing the required transformation. Our *Plan* will address the three key themes that Comptroller General Walker has highlighted: the financial, operational, and human capital challenges that must be met to sustain our universal service mission. But most importantly, the transformation plan, as the comptroller general points out, must address fundamental legislative reform.

Work on the transformation plan is proceeding in tandem with continued efforts to restore the Postal Service to a sound financial condition in spite of the current economic slowdown. As discussed with the committee in your recent oversight hearing, from the beginning of this calendar year, the Board of Governors and management of the Postal Service have initiated numerous steps to cut costs at a time when the sluggish economy held revenues below expectation. We have achieved record productivity and maintained our broad service commitments during this time. These efforts to restore balance between income and expense will continue as we work on planning for longer-term structural reform.

The U.S. Postal Service (USPS) mandate is to "breakeven" over time. Limited flexibility has been provided to bring down the debt in the statute or in our rate regulations. The rate process allows for reduction of debt through Prior Year Loss Recovery (over a nine-year period).

The rate process also provides for a contingency in the test year, which if unused, can help pay down the debt. There are a number of economic assumptions made when projecting the revenue requirement in the test year of a rate case. Should these assumptions go badly for the USPS, the contingency is used to cover the added costs or revenue shortfall.

Finally, revenue growth would, in theory, be the most effective way for the USPS to generate positive financial results to permit debt reduction. If growth is better than plan and/or costs are lower than plan, there is an opportunity to pay down debt. However, the process is flawed in that the burden of the rate process does not allow for annual increases in price. The limited revenue growth opportunities (particularly with First-Class Mail) and the inflexible rate process point to the need for pricing reform.

With respect to human capital transformation, we have an extensive effort under way to restructure the workforce, to reduce administrative staffing, and to reduce bargaining unit positions in accordance with applicable collective bargaining agreements. We are investing extensively in preparing future leaders, in making employees more productive, in improving labor relations, and leveraging their contribution with enterprise technology.

In a search for transformational changes that might be accomplished by the Postal Service and its customers together under existing authority, we have helped to organize a Mailing Industry Task Force to explore specific proposals for improving service and efficiency in our operations. I am personally meeting with our unions and management associations to listen to their views and work with all of them to explore what can be done to improve the long-term prospects for continued success of this vital public service, to which we are mutually committed.

We are working to improve the substantive quality of our interactions with our stakeholders. In the continued effort to advance needed legislative changes, on May 15, the Board of Governors wrote to your committee to provide its views on the kinds of reforms that seem needed to put the Postal Service on a more stable, businesslike basis for the preservation of universal service. These reforms address fundamental issues including the definition and preservation of universal service, more market-driven structures for pricing and product changes, and labor and employment reforms. We recognize that successful legislative reform will require building a coalition across a broad range of postal stakeholders. We continue to meet with members of Congress to learn their views and hear their concerns. We will be working with the Coalition to Preserve Universal Mail Service and others who also seek legislative reform, to exchange views, develop options, and advance the process.

The legislative reform process is dynamic. As we outline our plan to respond to the GAO's recommendations, the shape of the Comprehensive Plan is likely to change to accommodate the state of the discussion of postal reform legislation.

Recognizing that the timing and scope of our plan may change depending upon the legislative process, we expect to conduct discussions of the broad plan with stakeholders during the July-August time frame and to review the results of these conversations with the Board of Governors at their September meeting. We should then be ready to provide everyone with a draft Comprehensive Plan by September 30 of this year. Future updates to the plan will very likely be required.

The process of structural transformation of the Postal Service will be an ongoing, challenging task requiring regular communication and consensus building with all stakeholders. We have been participating in this important discussion of public policy since 1995 and this subject will continue to be a priority for the Postal Service. A transformation plan will need to propose an ongoing, evolving, common vision for the future of universal postal service for the benefit of all of America.

In summary, we find the GAO's recommendations to be very helpful, and we look forward to our ongoing interaction with Comptroller General David Walker and his staff.

Sincerely,



John E. Potter



June 25, 2001

Honorable Dan Burton
Chairman
Committee on Government Reform
House of Representatives
Washington, DC 20515-6143

Dear Mr. Chairman:

On April 24, 2001, Mr. Bernard Ungar, director, Physical Infrastructure Issues, of the General Accounting Office (GAO), wrote to former Postmaster General William J. Henderson. As provided by 31 U.S.C. 720, the head of a federal agency is required to submit a written statement to the oversight committees on actions taken on recommendations from the GAO. This letter fulfills that requirement.

Comptroller General David Walker testified before the House Committee on Government Reform on April 4. Two recommendations were made at that time (as summarized in Mr. Ungar's April 24 letter):

- (1) "The Service should provide summary financial reports to Congress and the public on a quarterly basis. These reports should present sufficiently detailed information for stakeholders to understand the Service's current and projected financial condition, how its outlook may have changed since the previous quarter, and its progress toward achieving the desired results specified in the comprehensive plan."
- (2) "The Service should develop a comprehensive plan, in conjunction with Congress and other stakeholders, such as the postal unions and management associations, customers, and the Postal Rate Commission, that would identify the actions needed to address the Service's financial, operational, and human capital challenges, and establish a time frame and specify key milestones for achieving positive results."

Since the time of this April 24 letter, my staff has met with the GAO staff on a number of occasions. Deputy Postmaster General and Chief Marketing Officer John Nolan and Chief Financial Officer and Executive Vice President Richard Strasser have met with the comptroller general, and I have spoken with Comptroller General Walker personally. Together we have developed a plan of action that will, we believe, be fully responsive to the GAO's recommendations. Further, we plan to continue to stay in close touch to address the concerns that Comptroller General Walker raised when he noted that the transformation of the Postal Service is at risk.

Financial Reports

With respect to this recommendation, Chief Financial Officer Richard Strasser makes a quarterly presentation of financial results to the Board of Governors at its public meetings. Mr. Strasser has met with the GAO and has discussed methods to provide additional transparency related to its financial condition. A major step in that direction, and in direct response to GAO's recommendation that summary financial reports to Congress and the public be made on a quarterly basis, in the near future we will place our Quarter III Financial Statements, similar to

what publicly traded enterprises provide, on our Web site at www.usps.com. We will continue this practice quarterly, with the audited fiscal year report as the Quarter IV version. Our FY2000 *Annual Report* is also available on the Web site.

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In summary, we find the GAO's recommendations to be very helpful, and we look forward to our ongoing interaction with Comptroller General David Walker and his staff.

Sincerely,


John E. Potter

APPENDIX B

**DATA DEVELOPED FOR MAILING INDUSTRY TASKFORCE REPORT:
MARKET INTELLIGENCE AND SEGMENTATION GROUP, 2001**

The Mailing Industry

Segment	Estimated Revenues Year 2000 (\$ billions)		
	Total	Domestic	International
Postal/Package Stakeholders			
Direct Mailing Services	180	180	
Indirect Mailing Services	<u>250</u>	<u>250</u>	
Direct/Indirect Mailing Services subtotal	430	430	
USPS	65	65	
Foreign Posts	65		65
Foreign Domestic Packages	15		15
Foreign Int'l Packages	11		<u>11</u>
UPS/FedEx/Airborne	<u>50</u>	<u>50</u>	
Subtotal	636	545	91
Mail Intensive Customer Segments			
Mail Order	111	111	
Publishing	100	100	
Printing*	24	24	
Subtotal	235	235	
Core Mailing Industry	871	780	91
Associated Stakeholders			
Advertising: US (Non-Direct Marketing)	134	134	
Advertising: Foreign	230		230
Domestic Telephone**	250	250	
Electronic Messaging	37	37	
Broadcast/Cable	60	60	
Electronic Payment Services	<u>14</u>	<u>14</u>	
Subtotal	725	495	230
Total	1,596	1,275	321

* An additional \$66 billion is included as direct/indirect mailing revenues in the Postal/Package segment.

**An additional \$20 billion is included in indirect mailing revenues related to Direct Marketing

Sources: ADL Evaluation of the Mailing Industry 10-98, USPS, Collography Inc, Dun and Bradstreet, Direct Marketing Association, Applied Value Inc.

The Mailing Industry

Segment	Employment (millions)
Postal/Package Stakeholders	
Direct Mailing Services	
Indirect Mailing Services	
Direct/Indirect Mailing Services subtotal	6.3
USPS	0.8
Foreign Posts	
Foreign Domestic Packages	
Foreign Int'l Packages	
UPS/FedEx/Airborne	0.6
Subtotal	7.7
Mail Intensive Customer Segments	
Mail Order	0.3
Publishing	0.9
Printing*	
Subtotal	1.2
Core Mailing Industry	8.9
Associated Stakeholders	
Advertising: US (Non-Direct Marketing)**	
Advertising: Foreign	
Domestic Telephone	1.9
Electronic Messaging	0.1
Broadcast/Cable	0.2
Electronic Payment Services	NM
Subtotal	2.2
Total	11.1

* 1.0 million are included in the Postal/Package-Mailing Services Segment

**0.7 million are included in the Postal/Package-Mailing Services Segment

NM: Not Meaningful (estimated as under 100,000 employees)

Sources: ADL Evaluation of the Mailing Industry 10-98, USPS,
Collography Inc, Dun and Bradstreet

APPENDIX C

TRANSFORMATION PLAN
STAKEHOLDER PRELIMINARY CONCEPT DISCUSSION
AUGUST – SEPTEMBER 2001

	Action Under Current Law	Moderate Legislative Change Three Alternative Approaches			Fundamental Structural Change
Scenario Components	Incremental Administrative Title 39 Model	Traditional Core Service Model	Enhanced Service Model	Enhanced Service / Structural Separation Model	Transformational Legislative Reform Corporatization Model
Mission	Current universal service definition	Current definition Possible Narrowing	Current definition New efficiency would be sought	Current definition New efficiency would be sought	Contract to provide universal service granted by federal government.
Legal Construct	Retention of current monopoly	Current monopoly Modification of non-profit status Possible modification of debt limit	Current monopoly Modification of non-profit status Modification of debt limit Authority to invest	Current monopoly for selected products and competitive freedom for others Modification of non-profit status Modification of debt limit Authority to Invest	Creation of a phased-in Postal Corporation leaving the ownership with the federal government for the time being
Service Offering	Today's services	Focus on current services with potential narrowing	Core plus enhanced products and services	Core plus enhanced products and service	Market defined service offerings
Pricing	Current rate-making process	Increased flexibility	Increased flexibility Reduction of scope of PRC	Increased flexibility Reduction of scope of PRC	Phase-out of price regulation and market place standards are created.
Governmental Control	Congress and Rate Commission	Reduced PRC role Base Closings type authority would reorganize oversight	Modification of the current PRC role Base Closings type authority for postal management	Modification of the current PRC role Base Closings type authority for postal management	Phase out of current oversight role and creation of marketplace standard
Legislative Change	None	Pricing Reform For- Profit Debt limit Base Closings Authority	Pricing Reform Investment Authority	New law creating a monopoly service and a competitive service	Legislation creating a corporate entity

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