Testimony of

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Chairman

On behalf of the

Postal Regulatory Commission

Before the

U.S. House Oversight & Government Reform Committee

February 7, 2017

Introduction

Chairman Chaffetz, Ranking Member Cummings, and members of the Committee on Oversight and Government Reform, good morning. My name is Robert G. Taub. I am the Chairman of the Postal Regulatory Commission (Commission). I am pleased to testify before you today.

Background

The Commission is an independent federal agency that is responsible for ensuring transparency and accountability of the U.S. Postal Service's operations and finances. Today, the Postal Service is a $71 billion operation with more than 600,000 employees. It is not quasi government, quasi private, or quasi anything – it is 100 percent part of the Federal Government, operating as an independent establishment in the Executive Branch. Yet the Postal Service receives no tax dollars for operating expenses and relies completely on the sale of postage, products, and services to fund its operations.

As a separate and independent federal regulatory agency, the Commission determines the legality of the Postal Service's prices and products, adjudicates complaints and fair competition issues, and oversees the Postal Service's delivery performance consistent with statutory requirements. Its mission is to ensure transparency and accountability of the Postal Service and foster a vital and efficient universal mail system. The Commission is the regulator, not the operator, of our nation's Postal Service – we do not manage the Postal Service, we regulate it. The Commission is composed of five Commissioners, each appointed by the President and confirmed by the Senate. The Commission receives an annual appropriation from Congress out of the Postal Service Fund.

Why a regulator for another government agency? Unlike almost any other federal agency, the Postal Service operates in a commercial marketplace while also having a large contingent of captive customers given the Postal Service's market dominance for certain products and services. The Postal Service is provided a statutory monopoly over mailboxes and the delivery of letters. The public interest role of a regulator in this case is clear: a need to protect the captive customers and ensure fair competition.

The Commission carries out this work with a very small budget and staff. Its current year appropriation is $15.2 million to regulate the $71 billion Postal Service. The David and Goliath analogy is sometimes apt. Despite a steadily increasing and complex workload, until this year, the Commission's annual appropriation had always been less than what it received in Fiscal Year (FY) 2008. FY 2008 was the last year that the Commission received its funds directly from the Postal Service rather than through the appropriations process. The Commission's budget in FY 2008 was $14.985 million for an authorized complement of 70 employees; 8 years later, the Commission's appropriation in FY 2016 was $15.2 million for an employee complement of 77. The FY 2016 appropriation of $15.2 million depicts the first marginal increase in 8 years above the FY 2008 level. The majority of the Commission's FY 2016 budget was allocated to pay and benefits ($10.7 million) with the remainder allocated for operating expenses ($4.5 million). This marginal increase in funding has allowed the Commission to begin filling deferred vacancies and funding previously deferred IT Infrastructure and cybersecurity initiatives. The Commission has also prioritized its limited resources to ensure we have the necessary funding for completion of the 10 year rate review study.

Commission Focus on Postal Service Financing

Commission rules require the Postal Service to file several reports with the Commission regarding financial results on a monthly, quarterly, and annual basis. The Commission staff internally analyzes these reports. Prior to 2014, the Commission's *Annual Compliance Determination* (ACD) included a chapter on the overall financial health of the Postal Service. However, because the ACD is focused on rates and service performance, it did not include a detailed analysis of other financial data provided in the Postal Service's *Annual Compliance Report* as well as its Securities and Exchange Commission equivalent Form 10-K filing. In 2014, the Commission developed a separate *Financial Analysis* report to provide greater clarity and transparency of the Postal Service's financial data and trends.

This year, the Commission will publish its fourth annual *Financial Analysis* report which not only reviews the overall financial position of the Postal Service, but also analyzes volumes, revenues, and costs of both Market Dominant and Competitive products. The report includes a chapter that analyzes the Postal Service's financial status in terms of profitability, solvency, activity, and financial stability using accounting ratios. I would like to highlight our preliminary observations and conclusions that will be reported in the Commission's FY 2016 *Financial Analysis* report.

Overview of USPS Finances: Liabilities Outstrip Assets Resulting in Low Liquidity

In FY 2016, the Postal Service had a total net loss of $5.6 billion, which is a $531 million deterioration from FY 2015. This decade of consecutive net losses posted since FY 2007 has increased the cumulative net deficit since FY 2007 to $62.3 billion. These continuing losses have significantly affected the financial position of the Postal Service by negatively impacting liquidity, requiring the Postal Service to use all of its $15 billion statutory borrowing capacity, and causing total net liabilities to far exceed total net assets.

In FY 2016, total revenue increased by $2.6 billion. Market Dominant revenue decreased by $0.7 billion while Competitive products revenue increased by $2.1 billion. A change in accounting estimate related to Forever Stamps resulted in an additional $1.1 billion in revenue.[1] Competitive product volumes continued to increase significantly in FY 2016, growing 14 percent over last year. This higher volume coupled with a Competitive product price increase (effective January 17, 2016) contributed to the increase in total revenue. Total Market Dominant revenue declined 1.5 percent from the prior year. CPI based price increases were not enough to offset declining volumes and the expiration of the exigent surcharge.[2] The exigent surcharge generated $1.1 billion in revenue in the first 6 months of the fiscal year before its expiration in April.

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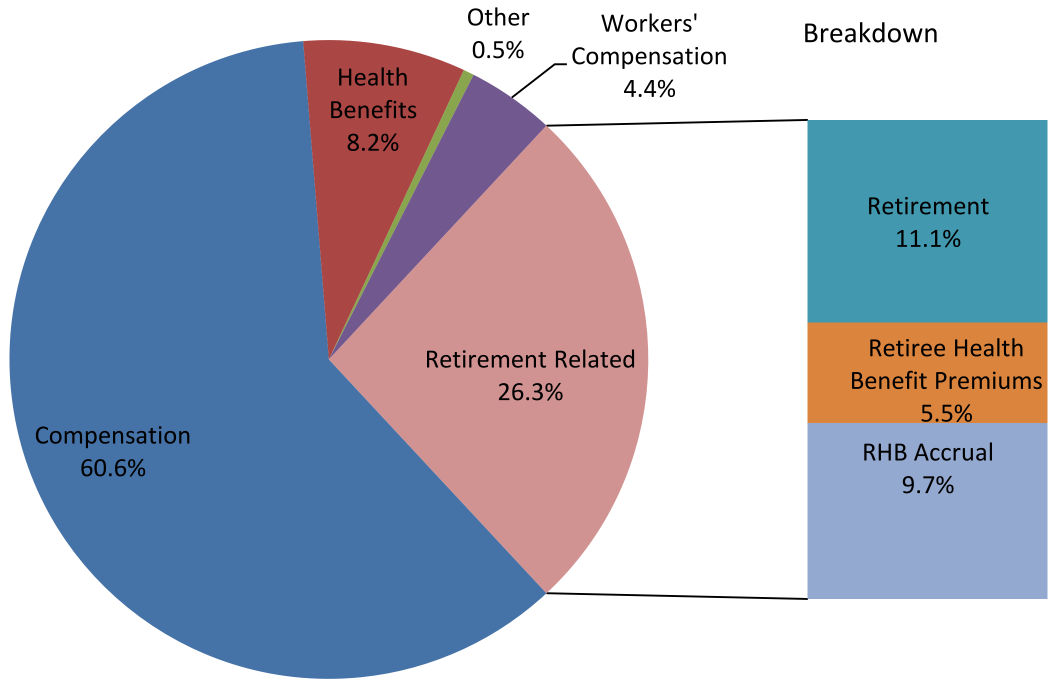
[1] Deferred revenue was increased to record omitted revenue from a recalculation of Forever Stamp usage included in Postage in the Hands of the Public (PIHOP) during the past years.

[2] This surcharge was permitted by the Commission after it found that the Postal Service had justified the recovery of additional contribution by showing a causal link between the extraordinary or exceptional circumstances of the Great Recession and mail volume losses.

Total expenses increased 4.2 percent or $3.1 billion in FY 2016. This increase is largely a result of higher overall compensation and benefits costs of $1.5 billion and an increase in workers' compensation expense of $0.9 billion. Compensation and benefits costs as a percent of total expenses remained the same as in the prior year at 78.6 percent. Compensation accounts for the largest portion of personnel expenses, representing 60.6 percent of total personnel costs. Retirement benefits are the next largest component of total personnel expenses at over 26.3 percent. Retirement benefits are comprised of statutory payments to the Postal Service Retiree Health Benefits Fund (PSRHBF), retiree health benefits premiums, employer contributions to the Federal Employee Retirement System (FERS) and the Civil Service Retirement System (CSRS) pensions and Social Security. The current premiums for annuitant health benefits along with the statutory prefunding PSRHBF payments account for 15.2 percent of total retirement related expenses.

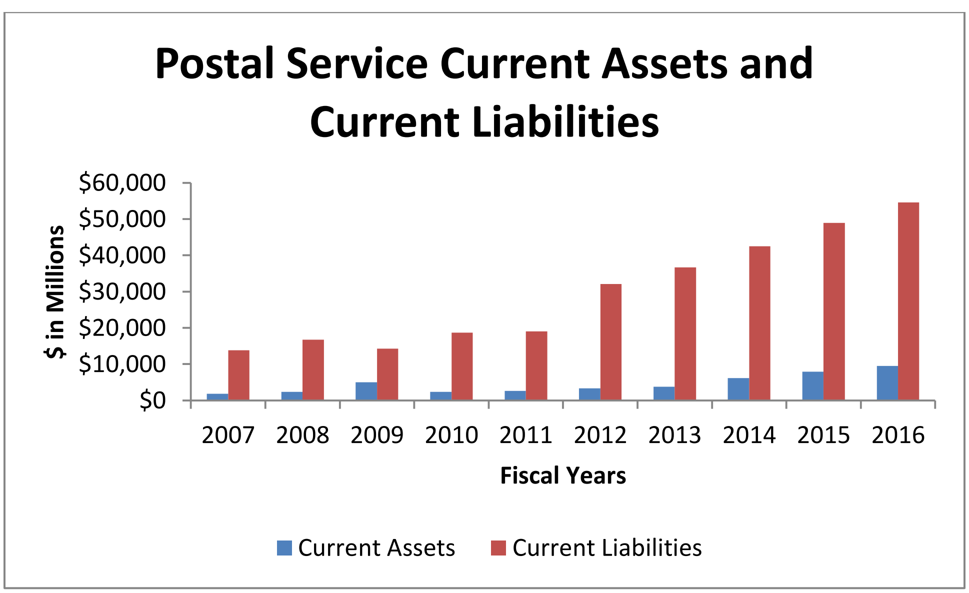
Percentage Breakdown of Total Personnel Expenses, FY 2016



An increase in workhours (the second consecutive increase since FY 2005) and the number of career employees (the second consecutive increase since FY 1999) increased compensation expenses by $0.7 billion. Retirement expenses also increased due to an increase in the FERS annuity rate from 13.2 percent of base pay to 13.7 percent of base pay and a supplemental payment to the FERS fund. Other benefits costs such as the current year premiums for retiree health benefits and the payment to the Department of Labor for workers' compensation costs also contributed to the increase in compensation and benefits. The $0.9 billion increase in workers' compensation expense was due to actuarial changes in the development of the estimate and changes in the discount rate. Non-personnel expenses, including transportation, increased in FY 2016. Further data on personnel related costs are detailed later in this testimony.

In the face of financial losses, over the past decade, the Postal Service has reduced the size of its workforce by about 175,000 career employees, cut labor related costs, and increased its productivity. Today the Postal Service delivers roughly the same volume of mail that it delivered in 1987, but with almost 160,000 fewer total employees. Yet even with these sizeable reductions, the Postal Service does not have the cash to pay down its debt or fully invest much needed capital in its operations.

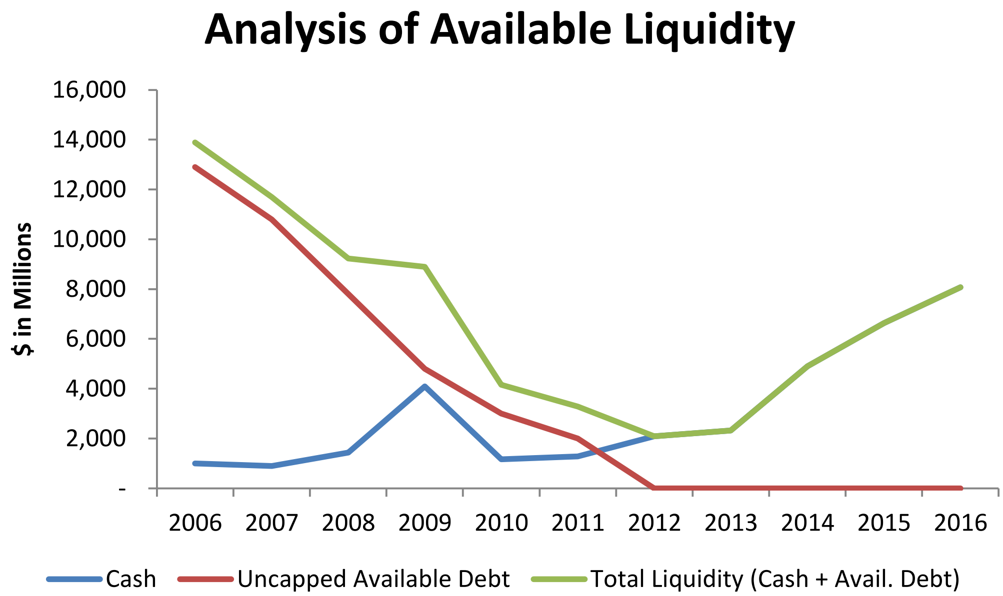
The significant gap between the Postal Service's net current assets and net current liabilities is of particular concern. The Commission finds that despite an improvement in liquidity during FY 2016, current assets, consisting mostly of cash and cash equivalents, continue to be insufficient to meet the payment of current liabilities.



In FY 2016, total current liquid assets increased by $1.5 billion from FY 2015; however, the amount of current liabilities rose by $5.7 billion, worsening the overall financial situation. Most of the increase in the current liabilities is due to the fact that the Postal Service did not make the $5.8 billion final statutory payment required in FY 2016 to the Postal Service Retiree Health Benefits Fund (PSRHBF). The total net current assets were $9.5 billion at the end of FY 2016, of which $8.3 billion was cash and cash equivalents. Net current liabilities at the end of this fiscal year were $54.6 billion, which included $33.9 billion in missed payments to the PSRHBF (the payments scheduled for FY 2011 through FY 2016). Also included in net current liabilities is $10.1 billion of the total $15 billion owed to the Federal Financing Bank. Further data on the PSRHBF are detailed later in this testimony in the additional information on personnel related costs.

These low liquidity levels in recent years have impeded the Postal Service's ability to make capital investments in infrastructure and hindered the growth and productivity enhancements in key assets required for primary postal operations. As the Postal Service noted in the FY 2016 Form 10-K statement, it now operates an aging vehicle fleet, increasing the need, and consequently the cost, for maintenance and repair. Also unmet is the need to invest in sorting and handling equipment to fully capitalize on business opportunities in the growing package delivery markets.

According to the Postal Service's FY 2016 Form 10-K statement, "If our operations do not generate the liquidity we require, we may be forced to reduce, delay or cancel investments in technology, facilities, and/or transportation equipment, as we have done in the recent past…. Additionally, our aging facilities, equipment and transportation fleet could inhibit our ability to be competitive in the marketplace, deliver a high-quality service and meet the needs of the American public…. An aging or potentially obsolete infrastructure could result in loss of business and increased costs."



On an *operational* basis the Postal Service's net income (i.e., before including the statutory prefunding accruals to the PSRHBF, any non-cash adjustments to workers' compensation liability, supplemental contribution to FERS Annuity and the adjustment for postage related to Forever Stamps for prior year usage) is $610 million. Most of this operational net income can be attributed to an increase in revenues from the Market Dominant and Competitive products rate increases, the exigent price surcharge on Market Dominant products, and the continuing growth in Competitive products parcels. The exigent surcharge, effective for the first 6 months of the fiscal year, increased revenue by an estimated $1.1 billion. The temporary surcharge was removed on April 10, 2016.

The increase in operating net income enabled the Postal Service to improve its liquidity position. Compared to FY 2015, the Postal Service increased its cash position by $1.4 billion. This increase in cash enables the Postal Service to begin planning for replacement of its capital assets, primarily delivery vehicles, and package sorting equipment. Yet, as noted, this increase is overshadowed by the increase in current liabilities, primarily due to the inability of the Postal Service to make the statutorily required pre-funding payments into the PSRHBF. Overall, according to the Postal Service, it has approximately 30 days of cash available to pay basic operating expenses. This consists only of available cash as the Postal Service has reached the statutory borrowing limit. The current level of Postal Service reported liquidity has improved since its low point in FY 2012, but total cash on hand plus total debt is almost half of what was available 10 years ago.

If a downturn in the economy or other circumstance should further stress the Postal Service's cash flow, it risks not being able to pay some of its bills and could, in a worst case scenario, run out of cash.

Analyzing Postal Service Financial Status: Profitability, Solvency, Activity, and Financial Stability

The Commission's *Financial Analysis* report uses "ratio analysis" to measure the profitability, solvency, and financial stability of the Postal Service. As detailed in the Commission's *Financial Analysis* reports, ratio analysis is used to conduct a quantitative analysis of information in a financial statement. Ratios are calculated from current fiscal year numbers and are then compared with previous years and historic averages to determine the Postal Service's financial performance.

The ratios explain the Postal Service's financial health and provide valuable insight into its past performance. The financial data used in the ratio analysis is derived from accounting information not adjusted for inflation, changing demographics, industry dynamics, or government regulations. Financial analysis used in the private sector may not be directly relevant to government agencies because revenue streams, equity structures, and management incentives differ. It is also difficult to determine a single measurement that signifies financial health for a government agency. Financial performance, although not a primary indicator of success, influences the fulfillment of missions and objectives for government agencies with a service-related mission, such as the Postal Service.

Some of the ratios calculated by the Commission for FY 2016 show a slight improvement compared to the previous year with the majority deviating greatly from the average of the last 10 years. The Commission's *Financial Analysis* report calculates "liquidity-related ratios" as well as "key ratios" related to sustainability.

Liquidity-related ratios are one of the most widespread indicators of an agency's solvency. Calculated using the Postal Service's financial results for FY 2016, they show an improvement over the prior year with values close to the historic 10-year average. The following table details the three liquidity-related ratios:

Ratio Analysis of Postal Service Financial Statements

Ratios	9/30/2016 Value	9/30/2015 Value	Change	Description of Ratio	Postal Service Historic 10 Year Average Value
Current Ratio	0.17	0.16	0.01	A current ratio is calculated by dividing current assets by current liabilities. It indicates an entity's ability to meet short term debt obligations.	0.16
Quick Ratio	0.17	0.16	0.01	This quick ratio is calculated by dividing liquid assets (cash, cash equivalents and short-term investments, current receivables) by current liabilities. It is a measure of an entity's ability to meet its short term obligations using its most liquid assets (near cash or quick assets).	0.15
Cash Ratio	0.15	0.14	0.01	Cash ratio is calculated by dividing absolute liquid assets (cash, cash equivalents and short-term investments) by current liabilities.	0.11

The improved liquidity-related ratios are largely a result of the increased cash on hand held by the Postal Service after exhausting its borrowing capacity. The Postal Service's working capital remains a negative value of $45.1 billion, deteriorating by $4.1 billion from the prior year. This means that the increase in current liabilities largely due to the missed retiree health benefit statutory prefunding payment of $5.8 billion significantly exceeded the growth in current assets, 92 percent of which is cash on hand.

The Commission's *Financial Analysis* report assesses three key ratios for Postal Service sustainability as detailed in the following table. Ratios for the current fiscal year as seen in the debt ratio and the current liability ratio have deteriorated compared to the prior year and the historic average for the past 10 years.

Ratio Analysis of Postal Service Financial Statements

Ratios	9/30/2016 Value	9/30/2015 Value	Change	Description of Ratio	Postal Service Historic 10 Year Average Value
Debt Ratio (debt to assets ratio)	3.22	3.10	0.12	This ratio is calculated by dividing total liabilities (i.e. long-term and short-term liabilities) by total assets. It shows how much the company relies on debt to finance assets.	1.88
Fixed Assets to Net Worth Ratio	(0.27)	(0.31)	0.04	This ratio indicates the extent to which the entity's cash is frozen in the form of fixed assets, such as property, plant, and equipment.	0.21
Current Liability Ratio	0.67	0.66	0.02	This ratio is calculated by dividing current liabilities by total (i.e. current and noncurrent) liabilities.	0.55

The accruing nonpayment into the statutory retiree health benefit fund and the long-term workers' compensation obligations have artificially skewed the Postal Service's current liabilities in relation to its assets. To reduce its debt ratio to historic averages, the Postal Service would have to significantly increase its current cash position or investments in capital assets and reduce its obligations to the PSRHBF.

The Postal Service's fixed assets to net worth ratio shows an insignificant improvement reflecting the slight increase in capital spending. However, the value still remains at negative 0.27, a result of recurring net losses accumulated over the last decade. A negative fixed assets to net worth ratio indicates the erosion through depreciation of the entity's long term tangible business assets, a critical investment for a viable entity.

The current liability ratio reflects the Postal Service's share of short term liabilities to total liabilities at 67 percent, increasing a percentage point from the start of FY 2015. The accrual of the unpaid statutory PSRHBF prefunding payments is included in current obligations, accounting for the increase in current liabilities. An increasing current liability ratio indicates increasing obligations due to be paid within the current year.

Understanding the Postal Service’s liabilities is critical, especially as the cash flows generated from operations render the Postal Service unable to meet its current obligations.

Evaluating Financial Strength: Altman Z-Score

The Commission’s *Financial Analysis* report also uses a financial analysis evaluating an agency’s financial strength, defined as the Altman Z-Score, to calculate the possibility of bankruptcy. The users, stakeholders, and the business environment vary between the Federal Government and the private sector. Stakeholders of private sector entities use financial analysis to make investment and credit decisions, and success is often measured by the company’s stock valuation. In contrast, Federal agencies are mission-oriented and measure success through the provision of service. Furthermore, unlike private sector firms, Federal agencies do not have direct shareholders whose income and wealth is affected by management decisions.

Financial analysis can be useful in both the Federal Government and the private sector. It can be used as a strategic management tool that provides the public with a concise and systematic way to organize the data in financial statements (e.g., balance sheets, income statements, and statements of cash flows) into meaningful information. The information derived from these indicators would provide the data needed to evaluate an agency’s financial condition.

Financial viability is affected by a combination of environmental, economic, and organizational factors, including the decisions and actions of management and the governing board. For example, the decline in volume of First-Class Mail, which has a high-contribution margin (the decline being a negative environmental trend), can lead to the erosion of a healthy cost coverage base. However, Postal Service management's response to this decline and constraints on management flexibility also affect its financial condition.

As detailed in the Commission's *Financial Analysis* report, the Commission calculated the Altman Z-Score to predict the probability of the Postal Service running out of cash to pay its creditors. Financial analysis evaluates the financial strength of an agency through the use of a variety of metrics. In conjunction with financial ratios, these metrics are used to gauge an entity's long-term viability. However, sometimes the agency's ratios reflect conflicting views. To help eliminate confusion, New York University Professor Edward Altman developed the Z-Score in 1968 as a tool to explicitly address the likelihood that a company could go bankrupt.

A quantitative model designed to predict the financial distress of a business, the Altman Z-Score uses a blend of the traditional financial ratios and a statistical method known as multiple discriminant analysis. The formula has achieved general acceptance by management accountants and auditors.

The Commission calculates the Altman Z-Score in its *Financial Analysis* report to predict the probability of bankruptcy of an entity with the attributes of the Postal Service. The Commission uses a factor model for a private non-manufacturer to evaluate the Postal Service's financial stability as follows:

Altman Z-Score = T1+T2+T3+T4 as denoted in the tables below.

The four performance ratios in the calculations are combined into a single score by weighting. The coefficients are estimated from a set of entities that have previously declared bankruptcy. A matched sample of entities is collected and matched by industry and estimated assets.

The Commission calculates that the Postal Service's Altman Z-Score was negative 6.4 on September 30, 2016. That means that there is a high probability that the Postal Service will go into financial distress. More commonly, a lower Altman Z-Score reflects higher odds of bankruptcy. This 2016 Altman Z-Score of negative 6.4 for the Postal Service is a setback from the FY 2015 score of negative 6.1 (and from the FY 2014 score of negative 5.7), and it is a significant deterioration from the positive score 10 years ago for FY 2006 of 0.2. Despite the results obtained, it should be mentioned that the Altman Z-Score as a predictor of the entity's bankruptcy probability is only relative, the structure of the Postal Service's ratios may be atypical, and interpreting the significance of the Z-Score would require deeper analysis by Postal Service management.

Altman Z-Score, FY 2006

Ratio	Calculation	Ratio Value on 9/30/2006	Weighting Factor	Product (col. 3 * col. 4)
1	2	3	4	5
T1	Working Capital/Total Assets	(0.3)	1.2	(0.4)
T2	Retained Earnings/Total Assets	0.2	1.4	0.3
T3	Earnings/Total Assets	0.0	3.3	0.1
T4	Capital/Total Liabilities	0.3	0.6	0.2
Altman Z-Score				0.2

Altman Z-Score, FY 2016

Ratio	Calculation	Ratio Value on 9/30/2016	Weighting Factor	Product (col. 3 * col. 4)
1	2	3	4	5
T1	Working Capital/Total Assets	(1.8)	1.2	(2.1)
T2	Retained Earnings/Total Assets	(2.2)	1.4	(3.1)
T3	Earnings/Total Assets	(0.2)	3.3	(0.7)
T4	Capital/Total Liabilities	(0.7)	0.6	(0.4)
	Altman Z-Score			(6.4)

The deterioration in the Postal Service's viability relates to the erosion of retained earnings caused by consecutive net losses, the statutory obligation to prefund PSRHBF benefits, and decreasing Retained Earnings/Total Asset ratio. A comparatively lower Working Capital/Total Assets ratio results from the continued lag in replacement of its almost fully depreciated existing assets. The significant drop in these two measures causes the negative fluctuation to the Postal Service Altman Z-Score when comparing FY 2016 with FY 2006.

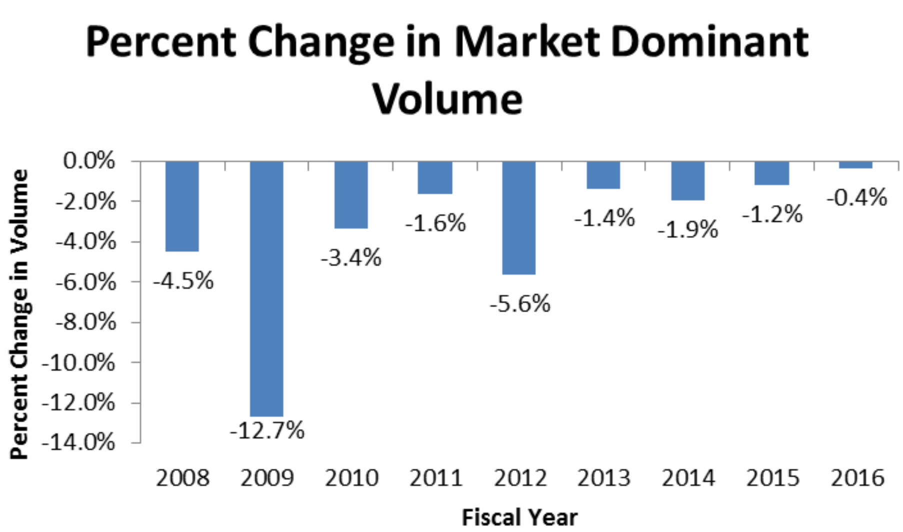
<u>Total Mail Volume: Continuing Decline</u>

Total mail volume in 2016 dropped to levels not seen in more than 29 years, and the Postal Service anticipates further reductions in total volumes for 2017. The aggregate decline in mail volume is the result of the economic recession of 2007 along with the acceleration of a long-term trend of mail migrating to electronic media. According to the Postal Service, the volume lost to electronic alternatives is not expected to return because the movement constitutes a fundamental and permanent change in mail use by households and businesses.

Market Dominant products: continuing decline, particularly in First-Class Mail

Over the last 9 years, Market Dominant products volume declined by approximately 52 billion pieces. Approximately 42 percent of the volume decline occurred in FY 2009 when Market Dominant volume declined 12.7 percent.

For specific products within the Market Dominant category, volume declines at different rates. In FY 2016, First-Class Mail volume declined by approximately 1.0 billion pieces, or 1.7 percent of total First-Class Mail, and Standard Mail volume increased by 840 million pieces, or 1.0 percent of total Standard Mail. These classes constitute the bulk of the volume of Market Dominant products overall. In FY 2016, First-Class Mail and Standard Mail accounted for 93 percent of the total mail volume. The decline in First-Class Mail is the most troubling as First-Class Mail contributes the most to the overhead costs of the Postal Service.



Competitive products: continuing increases but lower margin

Volumes and revenues for Competitive products, which are mainly parcels, increased 13.7 percent and 12.6 percent, respectively, in FY 2016. While Competitive products volume and revenue has grown consistently in recent years, its volume only makes up 2.9 percent of the total mail volume of the Postal Service. In addition, the margin (i.e., the overall cost coverage) on Competitive products is lower than the margin for First-Class Mail. In other words, the Postal Service earns more money from First-Class Mail than it does from Standard Mail or Competitive product parcels.

The continuous decline in First-Class Mail volume and revenue seriously jeopardizes the Postal Service's ability to cover its fixed overhead costs. As stated in the Postal Service's FY 2016 Form 10-K statement, " [The Postal Service must] generate approximately $2.50 in Shipping and Package revenue to replace the contribution from each $1 of lost First-Class Mail revenue, as the costs to process and deliver Shipping and Packages services were, and continue to be, substantially higher than the costs associated with *First-Class Mail*."

<u>Personnel Related Costs</u>

In FY 2016, total personnel related expenses, including the payment to the Postal Service Retiree Health Benefits Fund (PSRHBF) and the non-cash adjustments to the workers' compensation, increased by $2.4 billion or 4.1 percent from the prior year. The Postal Service continues to expense the amount payable to the PSRHBF, although it remains unable to make the actual payment into the fund. The last Postal Service payment to the PSRHBF occurred in 2010.

Beginning in 1989, the law required the Postal Service to pay the government's share of the premium for its own annuitants, which, in FY 2016, amounted to $3.3 billion. In 2006, the Office of Personnel Management (OPM) estimated that the Postal Service needed to generate $75 billion to cover benefits for all its current and future retirees. The 2006 Postal Accountability and Enhancement Act (PAEA) established the PSRHBF to collect these payments from the Postal Service. Until 2006, the Postal Service had $0 (i.e., zero, nothing) set aside to pay for its future retiree health benefits. In addition to the initial amount transferred from the Civil Service Retirement and Disability Fund of $17 billion into the PSRHBF upon enactment, the Postal Service paid $20.9 billion during the first 5 years after enactment of the 2006 law to meet this overly ambitious statutory requirement to prefund much of its future retiree health benefits. Presently, even though the Postal Service has not made any of the required prefunding payments in the past 6 years, there is $51.9 billion in the PSRHBF and a current unfunded amount of $52.1 billion (this is the portion that remains unpaid by the Postal Service).

Under current law, in addition to the Postal Service paying the normal cost amounts for retiree health benefits each year, the unfunded amount of $52.1 billion will be amortized over 40 years beginning in FY 2017. Also, in FY 2017, the PSRHBF starts paying the current year health benefits premiums.

From an operations standpoint, personnel costs increased by $1.4 billion in FY 2016 – a majority of which comprises compensation and retirement benefits. Compensation increased by $703 million while retirement benefits increased by $277 million. Compensation expenses grew over the previous year mainly due to obligated salary increases and the growth in Shipping and Package volumes, where, because of the size and shape of pieces, handling requires more workhours. As noted previously, retirement benefits expenses grew due to an OPM mandated increase in the agency annuity contribution rate for the FERS. Additionally, OPM notified the Postal Service that the FERS annuity account is underfunded by $3.6 billion as of the end of FY 2014. Under current law, the unfunded liability is to be amortized over 30 years, and this annual payment is estimated by OPM to be $248 million. The Postal Service has expensed this supplemental pension charge, but noted in its annual Form 10-K statement that it is reviewing OPM's underlying calculation regarding the unfunded pension estimate and has not yet paid this expense pending its review.

Summary: Significant Financial Obstacles for the Future

In summary, the Postal Service still faces significant financial obstacles for the future. The exigent surcharge was removed on April 10, 2016, because the Postal Service had collected all of the allowable $4.6 billion. With the growing liability of retiree health benefits, the inability to borrow for needed capital investments, and the continued loss of high margin First-Class Mail revenues, the important task of improving the financial condition of the Postal Service is daunting. Total liabilities exceed total assets by $56 billion.

Universal Service Obligation (USO)

The cost of providing universal service in the U.S. is estimated by the Commission to be more than $4 billion annually. Title 39 U.S.C. § 3651(b)(1) requires the Commission to estimate in its *Annual Report to the President and Congress* the costs incurred by the Postal Service in providing three types of public services or activities: postal services to areas of the Nation the Postal Service would not otherwise serve; free or reduced rates for postal services as required by Title 39; and other public services or activities the Postal Service would not otherwise provide but for legal requirements. In the *Annual Report* issued in January 2017, the Commission estimated that the total of these three categories is $4.24 billion.

Aside from the financial pressure of generating sufficient funds to remain solvent, the Postal Service must also be concerned about how to fund this $4 billion in universal service obligations. This obligation is in addition to those monies required to keep the mail moving, undertake capital investments, and pay other multibillion dollar obligations such as retiree costs.

How does the United States define universal mail service? In 2008, the Commission, pursuant to law, determined that the USO has seven attributes: geography, range of products, access to facilities, delivery frequency, prices/affordability, quality of service, and users' rights (or enforcement).

Other nations have imposed universal service requirements directly on their postal operator by statute, regulation, licensing, or contract. Countries like Australia, Canada, and Germany – just to name a few – have a detailed definition of universal postal service, with specific standards for delivery and retail access. Unlike other countries, the Commission concluded that the USO in the United States is largely undefined and instead is comprised of a broad set of policy statements with only a few legislative proscriptions. Aside from the annual appropriations mandate for the past 34 years to provide 6 days of delivery, Congress has rarely established rigid, numerical standards of minimally acceptable service for any of the attributes identified by the Commission. Rather, through its history, the Postal Service has been expected to use its flexibility to meet the needs and expectations of the Nation while balancing the delivery of service against budgetary constraints.

In the absence of a clear definition, particularly given the Postal Service's current financial challenges, each of us may have a differing view of what the Postal Service must provide in its services and operations to fulfill the USO, and since there is no specific agreed upon definition, all of our views will have different price tags. The Commission recommended in its 2008 report "that Congress consider and balance all the features of universal service as part of any review of changes necessary to preserve a financially viable Postal Service."

In 2007, the Federal Trade Commission (FTC) issued a report titled, *Accounting for Laws That Apply Differently to the United States Postal Service and Its Private Competitors, Federal Trade Commission, December 2007.* The report identified and quantified the economic burdens and advantages that exist by virtue of the Postal Service's status as a federal government entity and its postal and mailbox monopolies. The FTC determined, based on 2006 financial results, that the Postal Service's unique legal status ultimately put the Postal Service at an overall disadvantage in the Competitive product market. According to the FTC, the Postal Service's competitive products benefited from an implicit subsidy of between $39-$117 million per year associated with avoided Federal, state, and local legal requirements. However, the legal restraints imposed on it by Federal regulations cost the Postal Service an estimated

$330-$782 million a year in reduced efficiency in providing competitive products, according to the FTC.

Concluding Observations

Despite the bad financial news, there is good news, even if it is hard to see or seems overwhelmed by the financial position of the Postal Service. There is still strength in the system.

The Postal Service is the one government agency that touches every American on a daily basis; it is an organization that literally serves 155 million American households and businesses on a typical day. It facilitates trillions of dollars in commerce. According to the Envelope Manufacturing Association Foundation's Institute of Postal Studies, its 2015 Mailing Industry Job Study found that the Postal Service supports a $1.4 trillion mailing industry that employs 7.5 million people. The Postal Service is the key cog of a marketing and distribution system through which small and large businesses, nonprofit organizations, and consumers can transact business, advertise services, and distribute products. It is a significant driver of the Nation's economic engine and an essential piece of its infrastructure.

Throughout its 241-year history, the Postal Service has endured multiple economic recessions and a Great Depression. It has dealt with numerous disasters, which have interfered with mail delivery and strained the infrastructure. It has responded to these immense challenges by adapting, often despite predictions of failure or even its demise in the face of competition from new technologies.

With the inherent and underlying strength of the system, today's Postal Service can survive these challenges too. The fundamental problem as outlined in the Commission's testimony today is that the Postal Service cannot currently generate sufficient funds to cover its mandated expenses and also invest in critically deferred capital needs, such as new delivery vehicles and package sortation equipment. Despite the very serious and real financial problems, let's also keep in mind the good news – the strength in the system – and take some degree of hope knowing that this is the foundation that Congress and the Administration can build upon to find solutions. The strength in the system will be the engine that ensures the Postal Service will continue to meet its basic mission to "deliver."

Where Do We Go From Here?

The pressing question is "What needs to be done to improve the financial condition of the Postal Service?" The Commission has made recommendations on modifying the retiree health benefits funding and the computation of the liabilities for both retiree health benefits and pensions through separate studies on those topics, and also in its "*Section 701"* reports issued in September 2011 and November 2016.

Section 701 of the PAEA mandates that the Commission, at least every 5 years, submit a report to the President and Congress evaluating the operation of the changes made by the PAEA and to make recommendations for any legislation or other measures necessary to improve the effectiveness and efficiency of our Nation's postal laws. Appendix A to this testimony is the Executive Summary from the 2016 report and details the Commission's legislative recommendations. The Commission's report emphasized the starkly different environment faced by the Postal Service since the enactment of the PAEA – a time when volume was growing and the Postal Service was earning revenues that exceeded costs. In short, the Commission determined that the most important legislative recommendations it could make related directly to improving the volatile financial condition of the U.S. Postal Service.

I note that the bipartisan postal reform legislation, H.R. 756, the *Postal Service Reform Act of 2017*, introduced just last week by Chairman Chaffetz, Ranking Member Cummings, Subcommittee Chairman Meadows and Ranking Member Connolly, and Representatives Ross and Lynch is specifically designed to put the Postal Service on sound financial footing.

Today's hearing invitation noted that the hearing would discuss "the significance and potential implications of the Postal Regulatory Commission's ongoing review of the market dominant rate system." By law, after December 20, 2016, the Commission must review the price cap system for regulating Market Dominant products to determine if the system is achieving its statutory objectives and if it is not, to "make such modification or adopt such alternative system" to achieve the objectives. There are 9 objectives listed in the law that the modern rate regulation system must be designed to achieve, as well as 14 factors that the Commission must take into account. While each of the nine objectives must be applied in conjunction with the others, I would observe that relevant to the focus of today's hearing on Postal Service finances, objective number five is "[t]o assure adequate revenues, including retained earnings, to maintain financial stability."

When I last testified to the Committee in May 2016, I stated that the Commission had already well begun marshaling its limited resources to identify approaches to structure the review and schedule a process that would allow full and open opportunities for those interested to participate. I also committed that the Commission would provide notice to the public of its plans for the review well in advance of commencing it.

We delivered on those commitments. On September 1, 2016, during a public meeting of the Commission, I first announced Commission plans for that review. The Commission chose to notify the public in September so that all interested parties could prepare to participate in the review. The public was informed that the Order beginning the review would be issued on December 20; that the deadline for public comments to be submitted would be in early Spring of 2017; and that the Commission planned to issue an order which included its findings and, if necessary, preparatory rule-making information for any changes to the system in early Autumn of 2017.

On December 20, 2016, at 8:00 a.m., the Commission commenced docket RM2017-3 to review the price cap system for regulating Market Dominant products. In carrying out its statutory responsibility, the Commission has sought to achieve a balance of seeking views from the public while at the same time recognizing the importance of providing certainty and being decisive in its task. As a result, the Commission has designed a process which seeks targeted input from the public, but also deliberately moves forward with the aim of completing its findings by early Autumn this year (2017). The Commission is indeed mindful that H.R. 756, your new bipartisan postal reform bill, would mandate a process whereby final rules regarding modifications or changes to the rate system must be implemented by very early 2018. We are working hard to meet that goal.

There are no easy answers, but answer we must. I've outlined above some work that the Commission has completed and will be undertaking in this regard. I commend this Committee leadership for again coming together, as you did last Congress, to introduce legislation to address these challenges. The Commission stands ready to assist in your search for answers on behalf of our Nation's postal system and the more than 325 million Americans who depend on it.

On behalf of all four Commissioners and the entire hard working agency staff, thank you for the opportunity to testify today. I am happy to answer any questions.

Appendix A: Excerpt from the Commission's 2016 "section 701" report

(November 14, 2016)

EXECUTIVE SUMMARY

This marks the Postal Regulatory Commission's (Commission) second report under section 701 of the Postal Accountability and Enhancement Act (PAEA) of 2006. Every 5 years the Commission is required to issue a report and its first one was submitted to Congress and the President in 2011 (2011 Report). In general, the reports are to reflect the Commission's assessment of how well the PAEA is operating and is an opportunity to recommend legislation or other measures necessary to improve the effectiveness and efficiency of our Nation's postal laws.

The Commission's 2016 report, like its 2011 Report, emphasizes the starkly different environment faced by the Postal Service since the PAEA's enactment in 2006 – a time when volume was growing and the Postal Service was earning revenues that exceeded costs. Today, the Postal Service faces the reverse: mail volume that has declined more than 25 percent since 2006 coupled with a total net loss of $5.1 billion in FY 2015 - despite an exigent surcharge that generated an additional $2.1 billion in revenue.

Twice this year, the Commission was invited to provide testimony at congressional hearings focused on the steadily deteriorating financial condition of the U.S. Postal Service. Specifically, the Commission was asked to share with the Senate and House oversight committees key findings of its annual *Financial Analysis of U.S. Postal Service Financial Results.* Testimony delivered by Acting Chairman Taub described the fundamental problems facing the Postal Service: a growing liability for retiree health benefits; an inability to borrow for needed capital investments, such as new delivery vehicles and package sortation equipment; and the continued loss of high margin First-Class Mail revenues.

This fiscal year total net loss as of June 30, 2016, was $3.3 billion compared to a net loss of $2.8 billion for the same period last year, a deterioration of $0.5 billion. For this same time period, the Postal Service's total liabilities exceeded the total value of its assets by $53.7 billion. The Postal Service has recorded monthly net operating losses since the expiration of the exigent surcharge in April this year; and working capital for the 9 months which ended June 30, 2016, was negative $43.3 billion. The net deterioration of $2.3 billion in working capital from the beginning of the fiscal year was largely due to the growth in employee-related liabilities, including the statutory accruals for payments into the Retirement Health Benefits Fund (RHBF).

It is clear, the most important legislative recommendations the Commission can make relate directly to improving the financial condition of the U.S. Postal Service. While this year's 701 report will again discuss and make recommendations related to certain rate and service matters, along with improvements to Commission processes, the Commission places a particular emphasis upon the following recommendations:

- The Commission renews its recommendation from its 2011 Report that Congress modify the retiree health benefits fund prefunding level and payment schedule as a measure to improve Postal Service sustainability. Decreasing the funding target to one more in line with industry norms would provide much needed improvement in the Postal Service's assets to liabilities ratio.
- The Commission recommends lengthening the amortization period of the current unfunded liability. The current amortization period is 40 years. Extending the amortization period would free significant capital by reducing Postal Service annual payments.
- Further improvement in liquidity could be provided by allowing the Postal Service to use any available Federal Employees Retirement System (FERS) surplus, rather than requiring the surplus to be transferred to the RHBF. The Commission, therefore, recommends that Congress grant the Postal Service the authority to use available FERS surpluses to pay off current or future liabilities, including debt to the U.S. Treasury, pension liabilities, and retiree health benefit liabilities.

Finally, it must be noted that the timing of this report coincides closely with a significant Commission undertaking. By law, after December 20, 2016, the Commission shall commence a review of the price cap system for regulating Market Dominant products. The purpose is to determine whether the system is achieving its statutory objectives and if it is not, to "make such modification or adopt such alternative system" to achieve the objectives. Considering the breadth of this review, certain postal rate matters that would normally be addressed in this report will be deferred for consideration in December's review.

In this report, the Commission also details a variety of other recommendations for possible changes to discreet rate, service, and regulatory matters or processes. All of the Commission's recommendations are listed in Appendix A.

On October 20, 2016, the Commission sent its report to the Postal Service for review and an opportunity to comment, consistent with Section 701 of PAEA. On November 9, 2016, the Postal Service sent back its comments, which are attached at Appendix B.

Section 701 Report Recommendations

- The Commission recommends that Congress amend the current required RHBF prefunding level to comport with standard industry practice in both private and public sectors.
- The Commission recommends lengthening the amortization period of the current unfunded liability.
- The Commission recommends that Congress grant the Postal Service the authority to use available FERS surpluses to pay off current or future liabilities.
- With clearly defined and limited exceptions, the Commission recommends establishing a "soft floor" (a lower limit subject to certain exceptions) on worksharing discounts, which would benefit the postal community by providing appropriate pricing signals to incentivize efficient mail preparation.
- The Commission again recommends that the definition of a post office be clarified to adopt the plain meaning of the term post office, inclusive of branches and stations.
- The Commission recommends clarification on whether CPUs and nonpostal operation units also fall under the Commission's administrative review authority under section 404(d).
- The Commission recommends consideration of the duration of emergency suspensions of post offices.
- The Commission recommends that Congress consider clarifying under which circumstances the Postal Service is required to consult with the Commission when making proposed service standard changes.
- The Commission recommends that Congress clarify the meaning of section 3691 and the requirement that the Postal Service set service standards "in consultation with" the Commission.
- The Commission recommends that if the Postal Service is permitted to offer new nonpostal services, proposed nonpostal services be subject to the same regulatory review the Commission applied when reviewing existing nonpostal services pursuant to section 404(e)(3).
- The Commission recommends that where a proposed nonpostal service meets the statutory test, the Commission should have the authority to designate the service as a Market Dominant, Competitive, or experimental product.

- The Commission recommends that Congress consider adding language to 39 U.S.C. § 3661 that requires the Postal Service, upon receipt of the Commission's advisory opinion, and prior to implementation, to provide a written response to Congress addressing the Commission's recommendations.
- The Commission recommends that Congress consider raising the maximum revenue limitation on market test products thereby providing the Postal Service with more opportunities for advancement of new postal products to bolster revenue streams.
- The Commission recommends that Congress increase the maximum duration on market tests for experimental products.
- The Commission recommends Congress consider allowing the Postal Service to satisfy the requirements of section 3641(b)(2) by setting forth a reasonable basis for its belief that an experimental product would not cause market disruption.
- The Commission urges Congress to consider and balance all the features of universal service as part of any review of changes necessary to preserve a financially viable Postal Service.
- The Commission concurs with commenters that the postal industry and general public could benefit from an updated FTC Report with a more current accounting for the value of relevant legal differences between the Postal Service and its private competitors.

Robert G. Taub, Chairman (R)

Robert G. Taub was designated Chairman upon his reappointment as a Commissioner on December 12, 2016, for a second term, following his nomination by President Barack Obama and confirmation by the United States Senate. At the time of his designation and reappointment, he had been serving as Acting Chairman since December 4, 2014. He was sworn in as Commissioner in October 2011, following his nomination by President Obama and confirmation by the United States Senate. The Commission elected him Vice Chairman for calendar year 2013. Chairman Taub has more than 30 years of experience in public service. When first appointed as a Commissioner, Mr. Taub had been the Special Assistant to Secretary of the Army John M. McHugh since October 2009. In this role as an Army Department senior executive, he was one of the principal civilian advisors to Secretary McHugh, helping him oversee a workforce of more than 1.2 million people, and manage an annual budget over $200 billion. He was awarded the Army's Decoration for Distinguished Civilian Service.

Before his appointment to the Army, Mr. Taub served as Chief of Staff to U.S. Representative John M. McHugh (R-NY) for the preceding decade. As Chief of Staff, he oversaw the day-to-day operations of Representative McHugh's staff and offices in Washington, D.C. and Northern New York State. In a variety of leadership roles on the U.S. House Oversight & Government Reform Committee for 12 years, Mr. Taub also worked closely with Congressman McHugh on matters relating to the nation's postal and delivery sector. He crafted Representative McHugh's legislation for modernizing America's postal laws for the first time since 1970, culminating in passage of the Postal Accountability and Enhancement Act in 2006. Mr. Taub also helped Representative McHugh conduct hearings and investigations into postal operations that ultimately led to the enactment of a dozen other postal laws.

During his tenure in public office, Mr. Taub has addressed numerous national and regional conventions of postal employee organizations, mailing industry groups, and government and academic conferences both in the U.S. and abroad, on issues confronting the postal sector. The Inspector General of the U.S. Postal Service, postal employee unions, and mailing industry associations and nonprofits have all recognized Mr. Taub with several awards and honors.

Prior to his time with the House of Representatives, Mr. Taub worked for eight years at the U.S. Government Accountability Office (GAO), the investigative arm of Congress. As a senior policy analyst, Mr. Taub planned and directed evaluations for the Congress on environmental, banking, energy, and defense issues. Previous to his position with the GAO, Mr. Taub worked as a staff member for three different Members of Congress, a Member of the British Parliament, and state and county officials in upstate New York.

A native of Gloversville, New York, Mr. Taub earned an M.A. in Political Science, with a concentration in American politics, and a B.S. in Political Science with Honors, both from American University in Washington, D.C. He is a Fellow of the National Academy of Public Administration.