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U.S. POSTAL SERVICE

Financial Outlook and Transformation Challenges

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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.

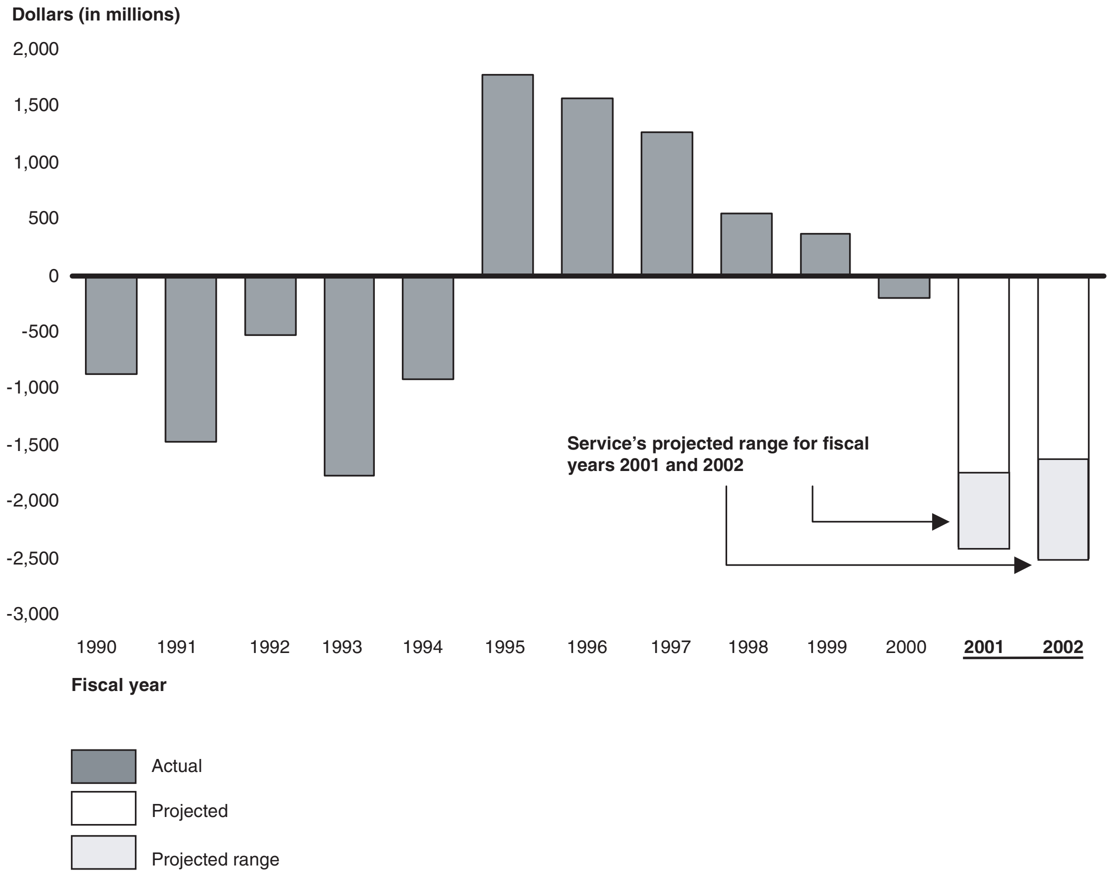
What is the Service's Current Financial Outlook?

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).

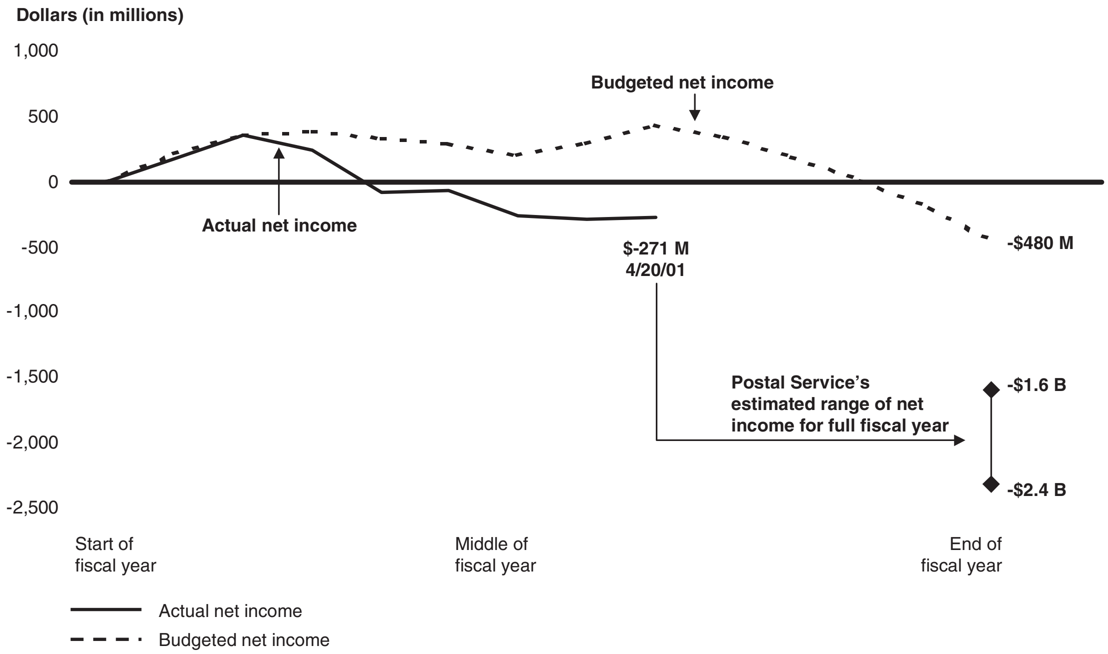
Figure 1: Postal Service Net Income From Fiscal Year 1990 through 2002



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).

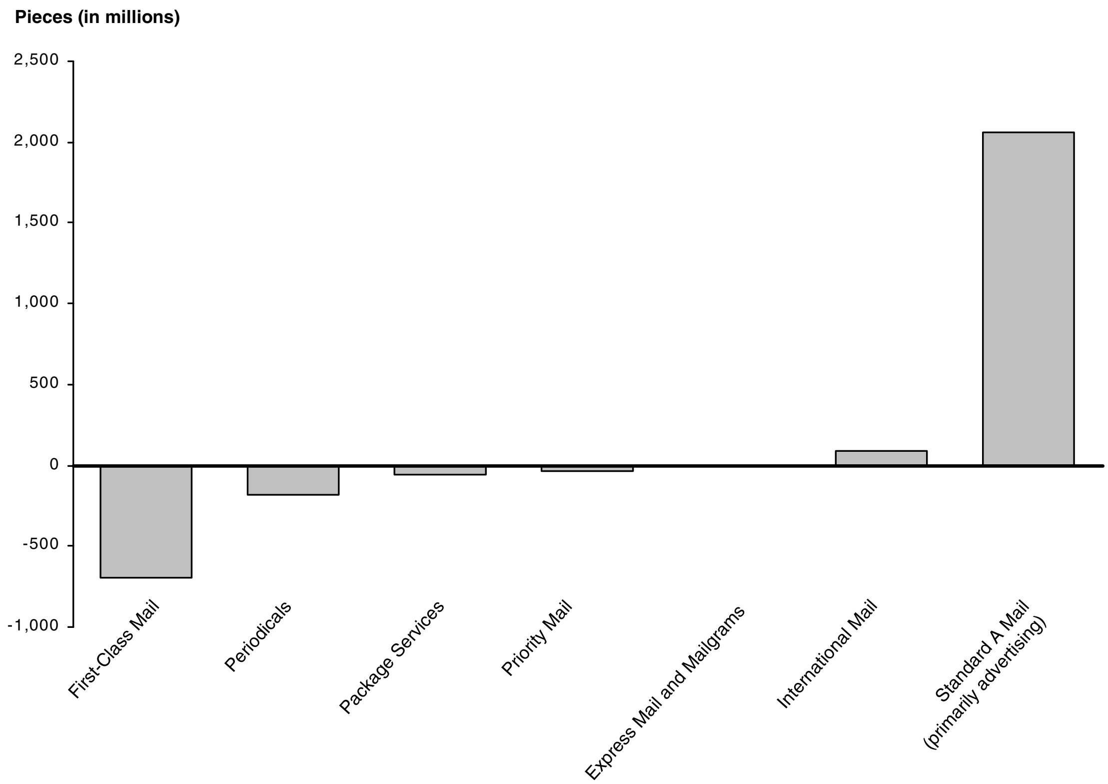
Source: GAO presentation based on U.S. Postal Service estimates, which are subject to change.

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.

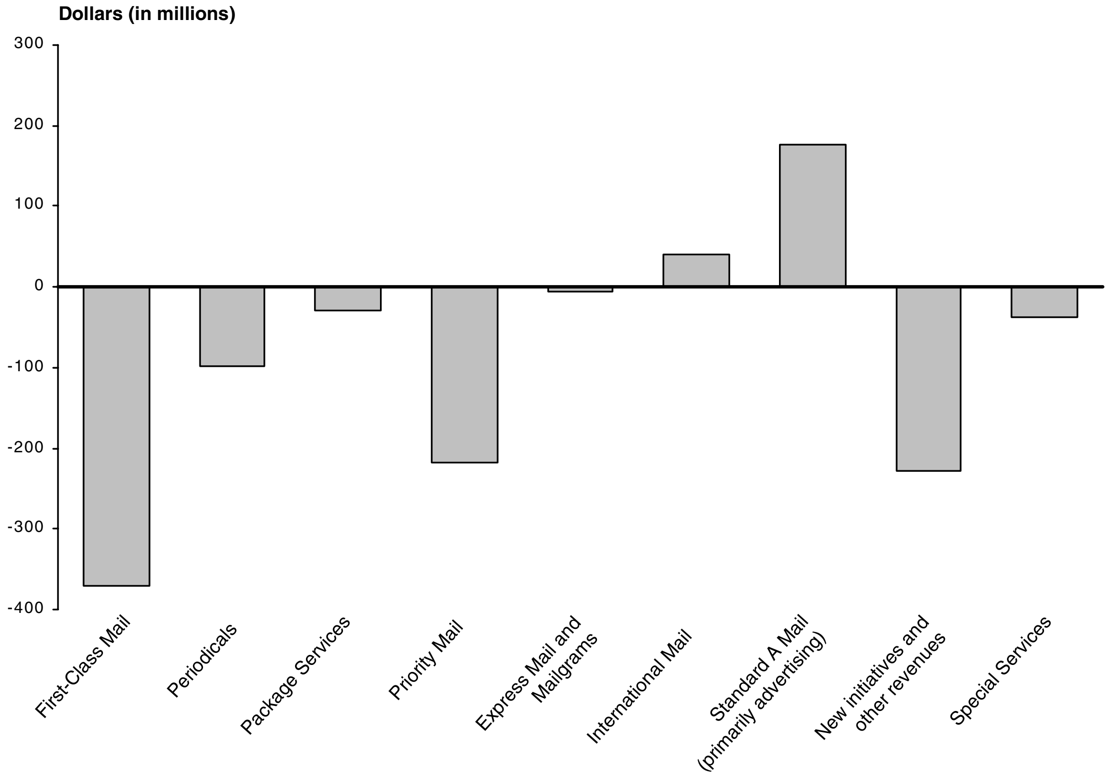
These mail volume shortfalls contributed to the Service's mail revenues being less than budgeted for in the first part of fiscal year 2001. First-Class and Priority Mail, when combined, account for close to two-thirds of the Service's mail revenues and generate revenues that pay for approximately three-quarters 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).

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[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.

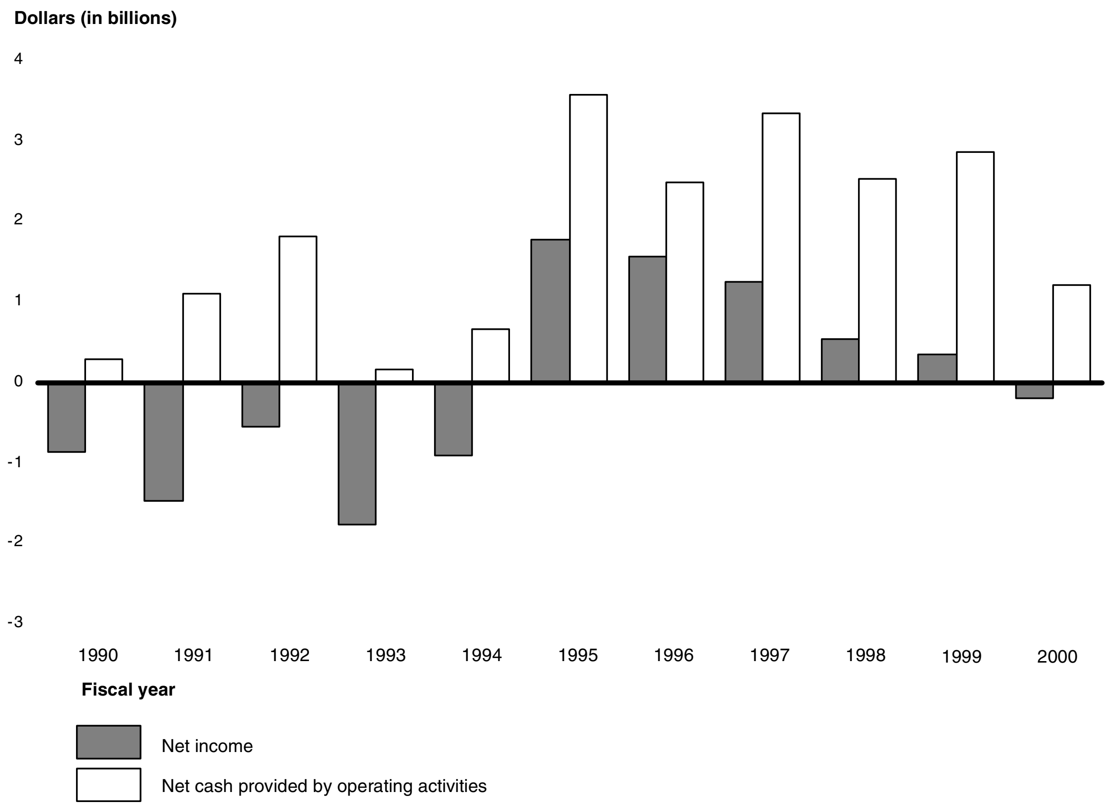
The Service Has Growing Cash Flow and Debt Challenges

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 accounting[4] 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



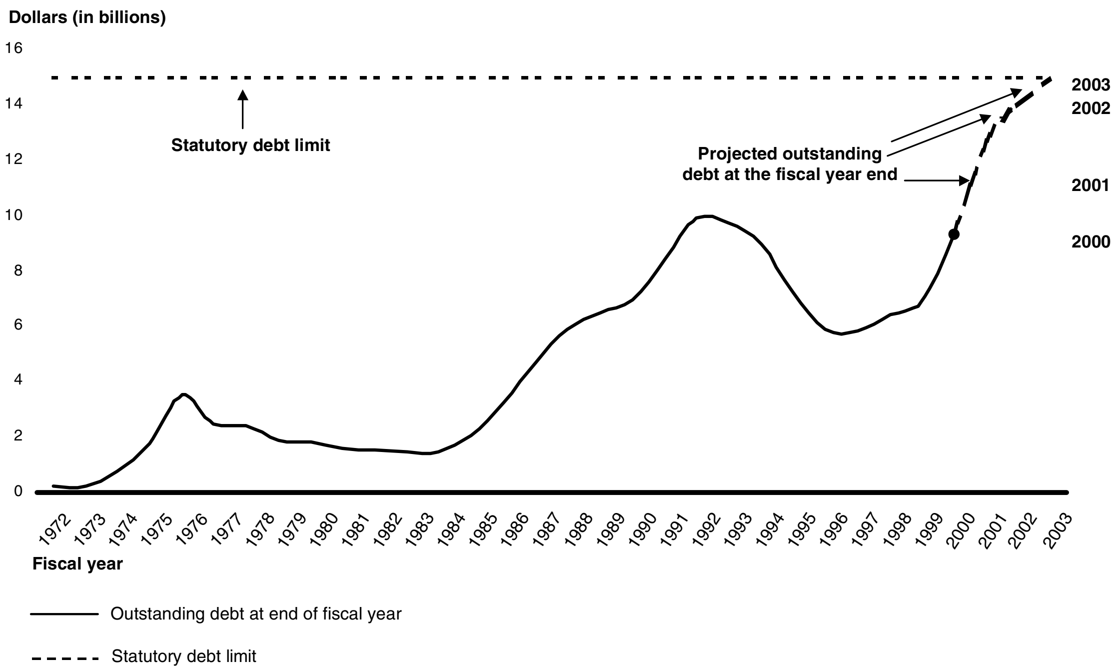
Source: U.S. Postal Service.

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

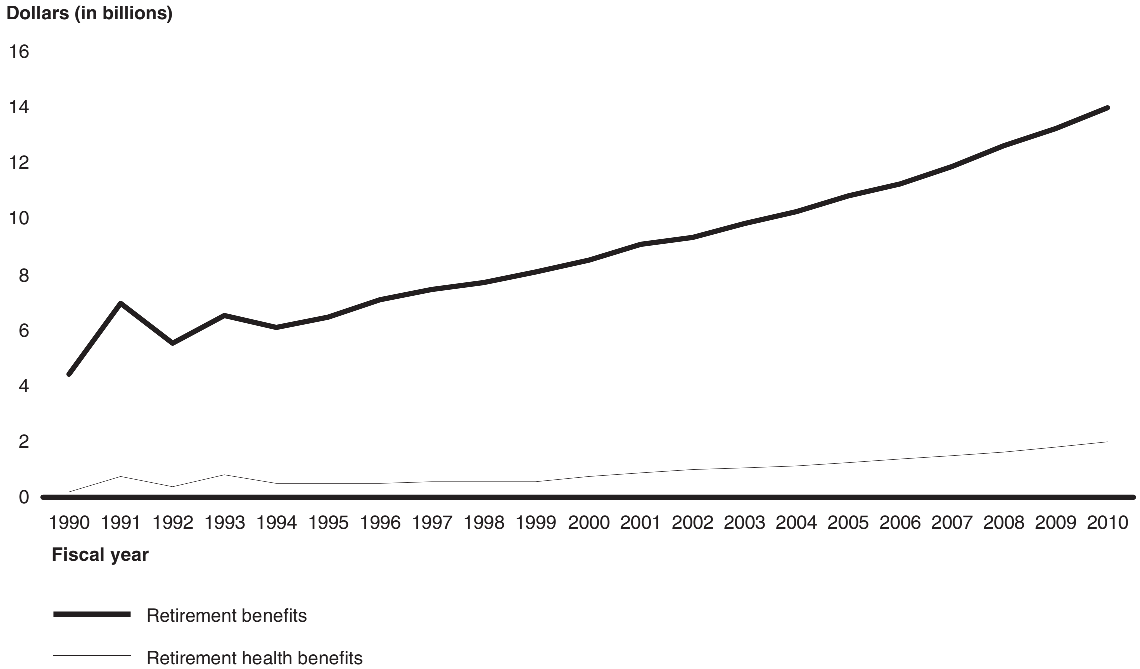


Source: U.S. Postal Service.

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.

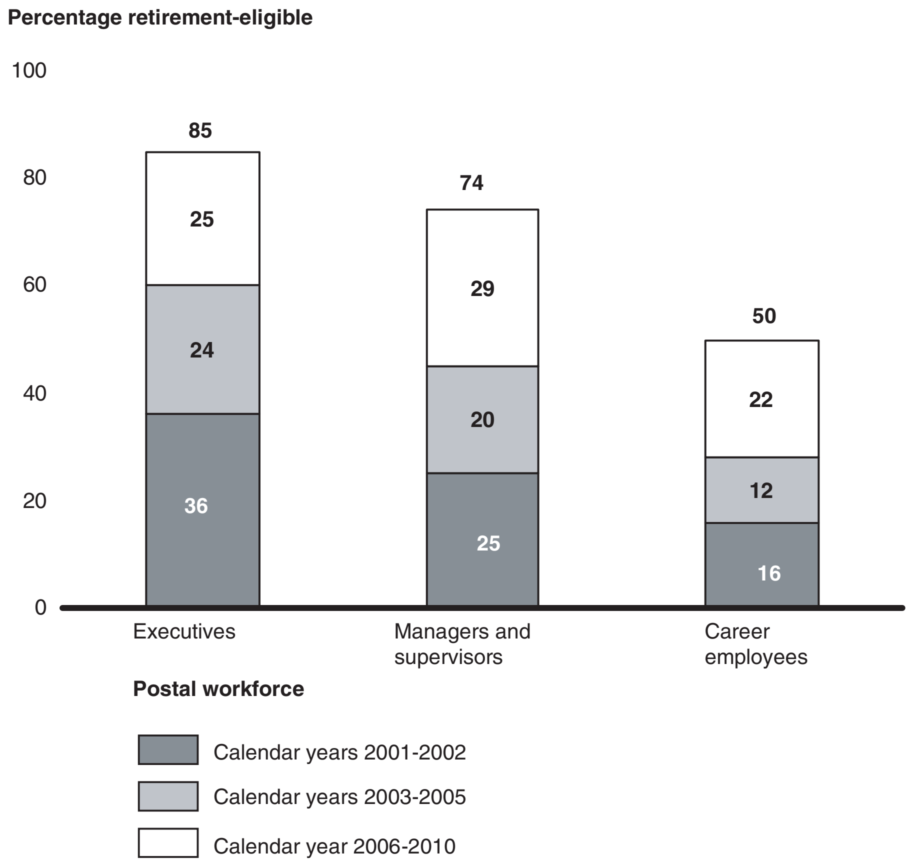
Figure 8: Postal Service Projects Increases in Retirement-Related Expenses



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.

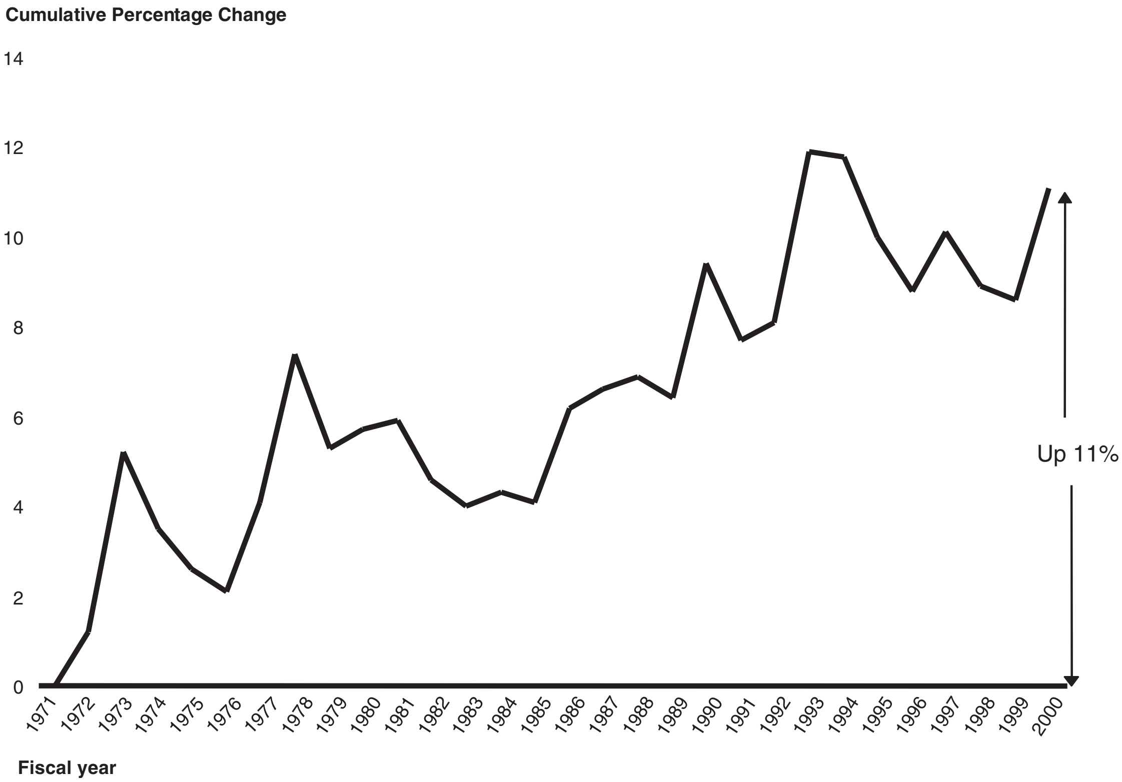
The Service has reported unfunded Civil Service Retirement System retirement liabilities of $32.2 billion at September 30, 2000. These liabilities represent the amount due to the Office of Personnel Management to cover Civil Service Retirement System pay increases and Civil Service Retirement System 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

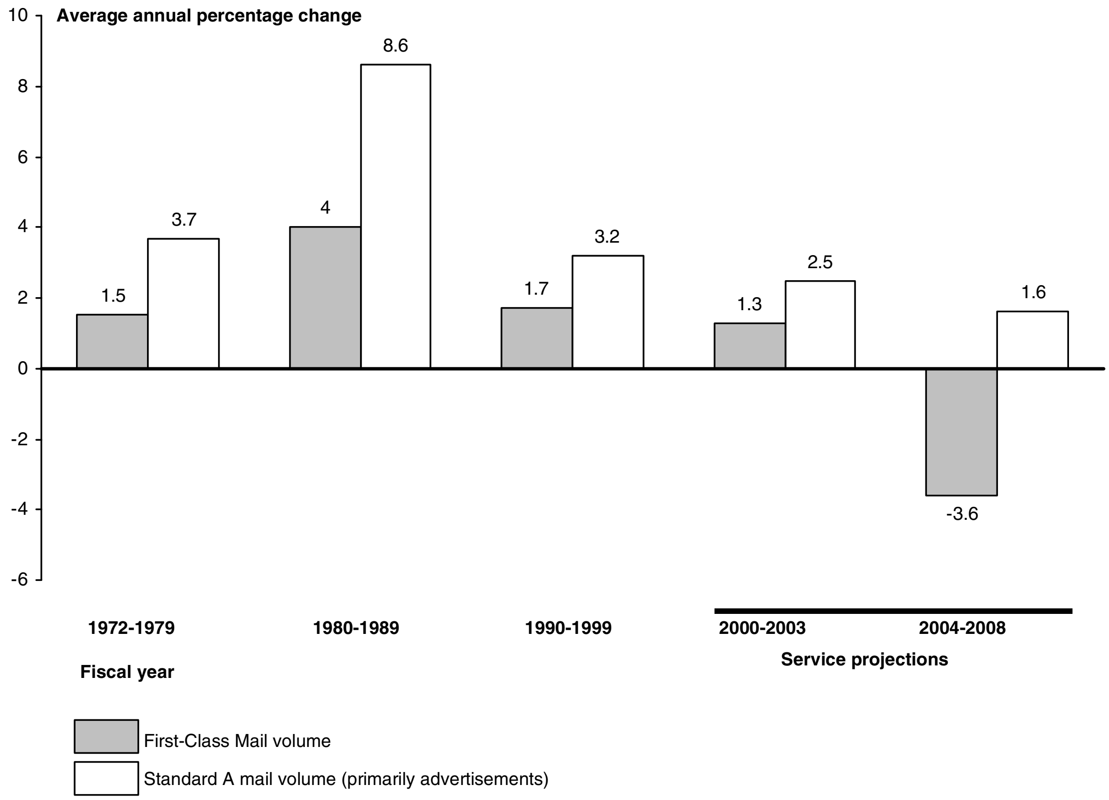
Changes in the marketplace, including greater competition, may lead to increasing financial difficulties for the Service and threaten its ability to provide universal postal service at reasonable rates while remaining self-supporting from postal revenues.

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

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