DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

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HEARING TESTIMONY
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ON REFORM OF THE UNITED STATES POSTAL SERVICE
BEFORE THE
COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

Madam Chairman and distinguished Members of the Committee, thank you for the opportunity to testify today on the need for comprehensive postal reform. I welcome this opportunity to underscore the Administration's strong interest in enacting comprehensive legislation to reform the United States Postal Service.

The Administration Supports Enactment of Postal Reform

The President has consistently articulated the need for comprehensive reform to set the Postal Service on sound, long-term operational and financial footing. The Administration has been holding regular meetings with Congress and many stakeholders to ensure that we hear everyone's perspective and that our message is heard as well. I would like to extend the Administration's thanks to the Members and leadership of this Committee for working with us on postal reform legislation and we look forward to continuing that productive dialogue going forward. The Administration also appreciates Postmaster General Jack Potter's strong leadership and hard work to drive change within the Postal Service, and we have enjoyed working closely with him and his staff.

I would like to begin my testimony by outlining the five principles of reform that the Administration has supported. These principles are as follows:

- Self-Financing - The Postal Service should be self-financed. This was the intent of the 1970 Postal Reorganization Act, but thus far it has never been accomplished. Today we are at a point, due in no small part to the Postal Civil Service Retirement System Funding Reform Act of 2003 (hereafter "the Postal CSRS Funding Reform Act"), P.L. 108-18, where we can ensure that the Postal Service covers all of its costs, including its massive unfunded liabilities, without potentially crippling effects on ratepayers.

- Transparency - The Postal Service should be a model of transparency. The past few years have highlighted the necessity for financial transparency in our nation's capital markets. We are all familiar with the limitations of the accounting standards that have been brought to light through the corporate accounting issues of the late 1990's and the collective responses from Congress, the Administration, regulators, and self-regulatory organizations over the past three years. While the Postal Service is a governmental entity, it operates as a monopoly. It has an enormous public trust and thus must not be exempt from the financial transparency requirements that we place on investor owned corporations. The public trust that the Postal Service holds demands a higher standard.

- Flexibility - The Postal Service should have the flexibility to operate as a business, including the ability to set prices, reduce costs, and adjust key aspects of its business in order to meet the challenges of a dynamic marketplace.

- Accountability - The Postal Service should be more accountable to all stakeholders. In order to protect ratepayers, mail recipients, taxpayers and universal mail service, there is a vital need for greater independent oversight given that the Postal Service is a monopoly that would be operating with greater commercial flexibility.

- Corporate Best Practices - The Postal Service should implement best practices of the corporate sector. This includes ensuring that the governing board is equipped to meet the responsibilities and objectives of an enterprise of its size and scope.

To more clearly outline the Administration's position in these areas, we provided a white paper in the 108th Congress listing a number of crucial long-term reforms. In this Congress, we took the further step of offering proposed legislative language to implement some of the more technical proposals. The Administration appreciates the Committee's willingness to address many of our concerns and include a number of our reform principles, and we look forward to working with you to further refine aspects of postal reform legislation consistent with these principles.

Reform must be Comprehensive

The Administration has always believed that reform must focus on the long-term health and viability of the Postal Service. There is an understandable temptation by some to tailor reform around the next rate case, but our horizon must be longer. Recognizing the importance of the Postal Service to our nation's citizens and commercial enterprises, the Administration is committed to ensuring the long-term financial and operational success of the Postal Service. We also recognize the systemic and structural challenges that the Postal Service faces in its business and believe that long-term reform will assist with both. The Postal Service faces an era of great change in which many believe that declining first-class volumes are unlikely to return. However, through reform and other initiatives collaboratively involving the Postal Service and mailers, it is entirely possible that new mail streams can be generated that provide a high value proposition to mailers. It is clear that the Postal Service must have a governing body, management team, and employees that are capable of recognizing the challenges and opportunities ahead with the insight, flexibility and skill to capitalize on them.

Flexibility

Pricing is a key part of the flexibility that the Administration believes the Postal Service needs. We support a hard rate cap, which provides that rates for any class of mail cannot rise more than the Consumer Price Index ("CPI") in any given year. The decision to support CPI as opposed to some other index was, in part, grounded on four factors:

1. the knowledge that overall postage rates have basically tracked CPI since 1972;

2. that productivity at the Postal Service has lagged the private sector by large margins since 1972 and therefore significant opportunities for a more productive Postal Service exists and this would enable it to operate within CPI;
3. to give the Postal Service stronger incentives to control its costs by discouraging it from simply passing costs on to ratepayers through a cost-based regulatory structure ; and
4. that wages generally rise faster than prices over time. This is largely due to increases in labor productivity. This difference in productivity allows firms to raise real wages without passing along costs to consumers through price increases. Generally, productivity improvements are expected to reduce prices.

We support the Committee's intent to establish a hard cap at CPI, and further support the Senate's version of an "escape clause," or exigency rate case, which establishes a very high bar to increase rates above CPI. This pricing flexibility will undo the current practice of irregular and lengthy rate cases that offer the Postal Service little managerial discretion and little or no predictability for the ratepayers.

We also seek to provide the Postal Service with flexibility on its cost side as well. We note that the Postal Service's $66 billion cost base provides significant opportunity for cost reductions without jeopardizing service quality or its universal service obligation. While some may dispute the absolute size of the potential reductions, it is indisputable that productivity at the Postal Service has lagged the private sector by large margins and that more effective management practices should be able to make significant progress in this area. One opportunity is in the underlying processing and distribution network and the potential to use this network in a more efficient manner.

Flexibility is not a blank check though. The Postal Service currently has the ability to negotiate its portion of the premiums for health and life insurance for its employees. The Postal Service has taken advantage of this ability and negotiated benefits beyond those offered by the U.S. Government. For instance, the Federal government pays 72 percent of an employee's health insurance premium while the Postal Service pays 85 percent of an employee's health insurance premium. Through this flexibility, the Postal Service has increased its costs by an additional $734 million. With respect to Basic life insurance, the Federal government pays 33 percent of an employee's Basic life insurance premium while the Postal Service pays 100 percent of an employee's Basic life insurance premium. Combined, the Postal Service has increased its costs for health and life insurance premiums by over $870 million annually above what the Federal government pays for most of its other employees.

We believe that it would be counter-productive to provide a list of specific cost reductions in statute, and instead have focused on a model where management has the flexibility to operate as a business within the constraints of a rate cap. This provides the right incentives for management without Congress or the Executive Branch micro-managing the business. In this way, the rate cap also drives greater board and management accountability, which is an important principle for the Administration.

Ensuring Self-Financing – Unfunded Liabilities

The Administration believes that comprehensive postal reform must require the Postal Service to cover all of its financial obligations, including its on and off-balance sheet unfunded liabilities. This is consistent with the statutory requirement that the Postal Service meet its responsibilities in a businesslike fashion by ensuring that revenues from the sale of products and services are sufficient to cover all operating costs. This concept of self-financing ensures that the Postal Service will operate in a manner that strengthens the financial and operational health of the Postal Service. It is important to recognize that since the 1970 Postal Reorganization Act, the Postal Service has never satisfied the statutory mandate of being fully self-financed. The Postal Service has accumulated approximately $75 billion of unfunded post-retirement health, pension and workers' compensation liabilities. Additionally, the Postal Service received approximately $27 billion of taxpayer funded appropriations since the 1970 Postal Reorganization Act.

While this may seem to paint a bleak picture of Postal finances, the Postal CSRS Funding Reform Act has provided a unique opportunity to substantially improve the financial health of the Postal Service. Specifically, the Administration has proposed to dedicate all the escrow created by the Postal CSRS Funding Reform Act to fund the unfunded post-retirement health obligations, which are approximately $64 billion. Without action, these unfunded liabilities grow to almost $100 billion in 2011, $208 billion in 2022, $422 billion in 2032 and over $1 trillion in 2045. We believe that the Postal Service should have a financing plan in place to ensure it can cover its post-retirement healthcare costs, and our proposal does that.

Some have said that the private sector does not pre-fund post-retirement health liabilities in the manner that we have proposed. We agree that the private sector generally has not fully pre-funded these liabilities, but note two important distinctions. First, in recent years, many firms that offer post-retirement health benefits have in fact established dedicated trusts to fund these liabilities as the seriousness of these obligations became apparent. More importantly, we recognize that the private sector has the ability to eliminate these, and other obligations either voluntarily or through a bankruptcy proceeding. These changes generally take the form of reduced or eliminated benefits.

We also recognize concerns from ratepayers over the 2006 rate case. The Postal Service has indicated that the need for the 2006 rate case is necessitated by the escrow established by the Postal CSRS Funding Reform Act and that without access to the escrow, rates must rise to compensate.

We believe that this analysis excludes the real reasons for the 2006 rate case. The reality is that any additional financial requirements of the Postal Service can be directly attributed to its inability to sufficiently reduce its costs since 2002, which is the date of the last rate increase. It is interesting to note that, if the Postal Service had the authority to raise rates under the CPI cap being proposed, the rates that would be in place today and in 2006 would be higher than what the Postal Service is currently proposing. While there are a lot of "puts" and "takes" in a business plan, I would like to address two components. Personnel will cost the Postal Service over $6.9 billion more in 2006 than it did in 2002 despite lower headcounts. This is based on actual results from 2002 and the Postal Service's projections included in its 2005 rate case filing. Fuel is also a significant component. We note that fuel costs for 2006 are projected to be over $700 million higher than in 2001, when the Postal Service filed its last completed rate case. The point of highlighting these two line items, which combined are well over two times the $3.1 billion rate increase that the Postal Service is asking for, is to demonstrate that the rate increase has its roots in the Postal Service's general cost structure and not linked to the escrow.

It is also important to realize that the Postal Service has already factored into rates, through the CSRS funding formula, the amounts that constitute the escrow, and therefore these amounts do not represent a "new" cost to be recovered. In other words, our reform proposal essentially replaces the "CSRS" expense line item with a new expense line item named "post-retirement health liabilities."

The Administration understands the concern over the 2006 rate case, but we also believe that all escrow funds should be committed to paying down unfunded liabilities rather than diverted in order to minimize a near-term rate increase. But the Administration does not view this as an either/or proposition, and we should consider exploring other alternatives to fully achieve both objectives. Before such alternatives can be considered, however, the Administration needs to see a clear path to enactment of postal reform legislation that includes the fundamental reforms that we have advocated.

Ensuring Self-Financing – Military Service

There has been a great deal of discussion about the Administration's position on the military service issue, and this hearing provides an opportunity to set the record straight. The decision in the Postal CSRS Funding Reform Act to allocate the $27 billion in retirement costs for the military service of the

Postal Service retirees was justified for many reasons which are being addressed by OPM's Acting Director Blair in his testimony.

In addition to the arguments that Acting Director Blair addresses in his testimony, I would also like to note that the allocation of military service retirement costs is fair and equitable because the Postal Service has been the beneficiary of significant taxpayer funded appropriations, which more than cover any perceived "unfair" attribution of the $27 billion of military retirement costs to the Postal Service. In addition to the $78 billion credited to the Postal Service through the Postal CSRS Funding Reform Act, the Postal Service has received approximately $27 billion in taxpayer-funded appropriations from the Federal government since enactment of the 1970 Postal Reorganization Act. If the goal is to revisit all of the assumptions that were the underpinnings of the 1970 Postal Reorganization Act and decades of Congressional decisions, it would be fair and equitable to revisit the appropriateness of the taxpayer-funded appropriations that the Postal Service has received. Using the same investment rates that OPM used in calculating the figure for CSRS over-funding, and based on the timing of these yearly Federal government transfers to the Postal Service, Treasury has calculated that the Postal Service would owe more than $200 billion to the Treasury for the use of the appropriations through FY 2003. We could elaborate on many other unique benefits the Postal Service accrues as a result of its special relationship with the Federal government, which include the ability to borrow up to $15 billion from the Department of the Treasury at below-market rates; exemption from federal income taxes, exemption from state and local taxation, and the power of eminent domain. So, during a period when the Postal Service has a statutory mandate to be self-financing, the Postal Service's cumulative performance has been bolstered enormously and in an extraordinary way by U.S. taxpayers, and as a direct benefit to ratepayers. I do not raise this point to call these transfers into question. However, I bring up this fact to further underscore the point that the Postal Service has benefited greatly during the past three decades, in an amount far exceeding the $27 billion currently under debate.

Transparency

The Administration believes that real financial and operational transparency is essential to postal reform. In the case of the Postal Service, the public interest and trust demands a very high level of transparency. We seek to obtain this enhanced transparency through SEC reporting standards and a robust, independent regulator. We are pleased that the Senate has seen fit to adopt many of the Administration's recommendations in this area.

Financial transparency is important for ratepayers, taxpayers, competitors, employees and management. The Administration believes that the Postal Service should be given great flexibility to set prices and to provide work-sharing discounts and enter into negotiated service agreements. While the Administration has dropped its requirement for audited product-line financial statements, we do believe that the Postal Service needs to develop and instill a culture that measures and understands its costs at a very fine level, which is consistent with the best practices in the private sector. While it is true that private sector companies generally do not issue product-line financial statements, they do in fact have them for internal purposes, which include performance measurement and the pricing of products, services and contracts. With the expanded flexibility that the Postal Service has on pricing, discounts and service agreements, the Postal Service needs to fully understand the true financial implications of its decisions.

In lieu of product-line financial statements, we have sought segment reporting which is consistent with SEC requirements. Given the uniqueness of the Postal Service, we have sought to define the segments. We believe that five segments represent a reasonable requirement based on today's business and would lead to segment reporting on First Class Mail, Standard Mail, Competitive Products, Periodicals, and Other. It is important to note that our language, while defining the segments, narrowed the reportable information by eliminating the SEC requirement to report "total assets." We did this because of recognition of the difficulty that this would pose for the Postal Service to establish what assets belong to which segments. Beyond the narrow issues that we have addressed, we are comfortable that the SEC's requirements and the exceptions that it provides for all registrants when items do not apply are sufficient for the Postal Service. It is unnecessary and unwise to allow the regulator to relax the SEC requirements.

Another aspect of financial transparency is the recognition of all of the Postal Service's liabilities, including those that are currently not on the balance sheet. The post-retirement health liability is the single largest liability excluded from the Postal Service's financial statements and the one that causes the most concern. This is because the Postal Service has excluded approximately $64 billion in costs from the rate base. We are also concerned by the Postal Service's acknowledgement that it has included the workers' compensation liabilities in its rate base yet it still has $7.6 billion of unfunded workers' compensation liabilities. The Postal Service has used funds that were part of its workers' compensation expense requirements in previous rate cases for non-workers' compensation related expenses.

The issue of what information is confidential and who determines whether it is confidential is an important issue of transparency. We fully understand that certain information of the Postal Service is confidential as is common in both the government and private sectors. We agree with the Senate's approach to this matter: to allow the regulator to be the final arbiter of what materials should be confidential rather than the regulated entity.

Accountability

Accountability will result in many ways through our reform efforts. A hard rate cap that has a strict escape mechanism will drive management accountability. A strong regulator will drive accountability, and real financial transparency will drive accountability.

We also believe that a revised compensation structure for senior management will help drive accountability. It is critical to provide flexibility to the Board of Governors to fairly compensate senior executives in a manner that will help attract and retain the very best. We all recognize that even with this flexibility, it is not possible to provide the same private sector compensation opportunities. But it is a step in the right direction as we demand a more private sector like focus on business operations, productivity and financial performance. In another accountability measure, we believe that the regulator should have a review role in the new compensation flexibility.

Conclusion

Congress now has a unique opportunity to take decisive action on a comprehensive postal reform bill that will set the Postal Service on the course to financial and operational stability. We believe that the five principles discussed will align the incentives, create a performance oriented culture, and ensure the proper accountability for the largest monopoly in the world. Thank you for the attention you are paying to this critical aspect of our country's economy. The Administration remains prepared to actively work with you to craft a comprehensive reform bill that will stand the test of time in an enormously dynamic market. We believe it critical that reform legislation result in a sharing of sacrifice with all stakeholders, and characterized by the five principles we have articulated.

Once again, I thank you for your kind invitation to appear today.