



**UNITED STATES  
POSTAL SERVICE**

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# **INTEGRATED FINANCIAL PLAN FISCAL YEAR 2005**

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**OPERATING PLAN**



**CAPITAL PLAN**



**FINANCING PLAN**



## PREFACE

The United States Postal Service Integrated Financial Plan (IFP) for Fiscal Year (FY) 2005 has been developed by management and is hereby submitted to the Board of Governors for review.

The Board relies on this annual planning document as the primary benchmark of the Postal Service's estimated business needs and results as they regularly review, evaluate and decide upon issues relating to the organization's financial condition and operations.

The IFP integrates three distinct annual business plans for FY 2005: the Operating Plan, the Capital Plan and the Financing Plan. Each of these plans has been constructed from the basis of estimated FY 2004 operating results, subject to change, and each is dynamically linked to another. These business plans were developed under our four phase management cycle: Establish, Deploy, Implement, Review. The Establish Phase, setting organizational indicators and targets for the fiscal year, began in December, 2003. The Deploy Phase, calling for plans to achieve the targets and negotiating resources, began in March, 2004. The Implementation Phase will begin with the new fiscal year and the Review Phase is ongoing. The Capital Plan allocates funds for construction and purchase of facilities and equipment that will improve service and infrastructure and generate future efficiencies and service improvements. These investments are primarily funded by cash flows generated from the Operating Plan.

This document provides: an Executive Summary; a Statement of Underlying Assumptions and Financial Realities that informed the development of this Integrated Financial Plan; and the complete Integrated Financial Plan for FY 2005 including a section stating the risks.

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## EXECUTIVE SUMMARY

The FY 2005 Integrated Financial Plan incorporates the Operating, Capital and Financing Plans that are built upon projected FY 2004 financial results. With a projected FY 2004 net income of \$2.6 billion, the FY 2005 operating plan results in a net loss of \$192 million. For the second consecutive year, revenue is expected to decline from the previous year while expenses will be driven up by inflation. The increase in expenses will occur despite reduced annual operating expenses of \$4 billion that have been achieved in the first three years of the Transformation Plan and despite adjustments to retirement payments to prevent further overpayment.

### ***Operating Plan - Revenue***

FY 2004 revenue will decline from that of the previous year by an estimated \$187 million. While mail volume is projected to increase by 1.4 percent, or 2.9 billion pieces, the decline in revenue is due to falling volume in high revenue-per-piece mail.

Economic forecasts for FY 2005 estimate that GDP growth will moderate from FY 2004 levels and retail sales growth will slow, as will nonfarm employment growth. These are key drivers of mail volume growth. Accordingly, total revenue is projected to drop again in FY 2005, falling by \$237 million from estimated FY 2004 revenues. Standard Mail volume will surpass First-Class volume for the first time. First-Class Mail is expected to decline by 2.2 percent or 2.1 billion pieces. Replacing its contribution to covering institutional costs would require an additional 5.5 billion pieces of Standard Mail (using FY 2003 cost data) but the forecasted growth is 4.0 percent or 3.8 billion pieces. That is a major cause of the net loss next year.

### ***Operating Plan - Expense***

Operating expenses are estimated to total \$65.9 billion in FY 2004 and will increase to \$68.5 billion or by 3.9 percent in FY 2005. Health benefit costs are expected to increase \$750 million in FY 2005. Cost-of-living allowances (COLAs), tied to increases in projected consumer price indices, are expected to add \$650 million to expenses during the coming year. Rising fuel costs will also impact expenses. The plan offsets these cost pressures somewhat through continued cost reductions of \$1.4 billion, primarily generated by workhour reductions.

### ***Capital Plan***

In FY 2004, capital commitments will underrun the plan by \$1.4 billion to end the year at \$1.8 billion in commitments. The underrun is due to delays in three capital projects. The FY 2005 capital commitment plan reflects the priorities outlined in the Transformation Plan. It is set at \$3.3 billion to provide for those delayed projects and allow additional projects producing positive returns to be developed.

### ***Financing Plan***

In FY 2004, the cash flow from operations will allow debt to be reduced by as much as \$5.5 billion. Capital cash outlays are below forecast and more cash from operations, resulting from productivity achievements above plan, is available to retire debt. The debt balance at the end of FY 2005, if the operating plan is met, will be in the neighborhood of \$1 billion.

### ***Risks***

The FY 2005 Integrated Financial Plan is the result of an extensive development process, in which numerous scenarios were examined. A solid foundation exists for achieving the plan. However, risk factors must be acknowledged. Primary risks relate to economic growth as a key driver of mail volume and revenue; inflation as a driver of core expenses; health benefits costs which are outside management control; and accelerated technological impacts on mail usage.

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## STATEMENT OF UNDERLYING ASSUMPTIONS AND FINANCIAL REALITIES

### ***The Economy***

The primary economic risks to this plan are weaker growth and inflation. In the last quarter of FY 2004, economic growth continues to be weaker than had been projected. Gross Domestic Product (GDP), which expanded by more than 4 percent for four quarters, slowed to less than 3 percent in the third postal quarter (April – June) of 2004. Those four quarters of growth provided noticeable lift only to Standard Mail volume, despite a second year of rate stability for all classes of mail. Inflation, which had been holding at annual rates below 2.5 percent for more than a year, rose above 3 percent in May and June, 2004, causing an unusually high increase in COLA payments. The welcome decrease in the reported rate of unemployment to 5.5 percent in July was paired with weak growth in new jobs for the second consecutive month. Nonfarm payroll employment is a key driver of advertising mail volume.

### ***Financial Challenges***

Postage rates will have been steady for three full years on June 30, 2005. Contribution from the last rate increase, set to cover costs in FY 2003, has been completely consumed. Without the retirement payment adjustment, discussed below, a rate increase in FY 2005 would have been necessary.

The principal financial challenges the Postal Service expects to face in FY 2005 are declining revenue with slightly increased volume and cost inflation. Mail volume growth and consequent Postal Service revenue growth depend on economic growth, the underlying demand for postal products and services, and the attractiveness of competitive alternatives. The trends of lower mail volumes in First-Class Mail, Periodicals and Priority Mail will continue through FY 2005, but improvements in Standard Mail, International Mail and Package Services will partially offset these volume declines.

Major anticipated Postal Service cost increases in FY 2005 are personnel costs deriving from increased health benefit costs for employees and retirees, inflation-based increases in cost-of-living allowances (COLAs), and employee pay increases. Rising energy prices have put more pressure on non-personnel expenses than has been experienced in several years. Although fuel prices have moderated in recent weeks, they remain relatively high. The Postal Service consumes approximately 800 million gallons of gasoline, diesel, and jet fuel each year. Therefore, a one-cent increase in fuel prices, sustained for a year, adds approximately \$8 million annually to transportation expenses. Increased energy prices also impact utility costs. Adding to both personnel and non-personnel costs, is the ever-expanding delivery network.

### ***Legislative Impacts – Civil Service Retirement System Funding and Postal Reform***

The FY 2005 IFP incorporates the third and final year of “savings” from Public Law (PL) 108-18: The Postal Civil Service Retirement Funding Reform Act of 2003. This Act modified Postal Service funding of its obligations to the Civil Service Retirement System (CSRS) to preclude further over-funding. The difference between contributions that the Postal Service would have made had the law not been enacted and the contributions made by the Postal Service under the Act are defined as “savings”. The Act required the Postal Service to use “savings” in FY 2003 and FY 2004 (\$3.4 billion and \$2.8 billion, respectively) to pay down debt and in FY 2005 (\$2.8 billion) to maintain the level of postage rates implemented in FY 2002.

The FY 2005 IFP fulfills the requirements of the Act. However, the “savings” from the Act have been completely consumed in absorbing inflation in costs and contribution loss due to declining revenue that has resulted from mail mix and volume changes. Further, although the “savings” have been consumed, the Act requires that the calculated amount of “savings” in years after FY 2005 be placed in escrow for use as to be determined by Congress. This will require an increase in postage rates of approximately 5 percent in FY 2006 above the normal rate increase to generate this fund. This requirement increases in subsequent years, which would lead to more frequent rate increases. Also, the Act requires the Postal Service to fund the full value of retirement benefits attributable to the military service of its CSRS employees. Until passage of PL 108-18, military service benefits had been a Treasury Department obligation and remains so for virtually all other federal agencies.

PL 108-18 mandated a review of both the CSRS military service retirement obligation and the escrow requirement. The Postal Service recommended that the obligation to fund military service costs revert to the Treasury Department and that the escrow provision be eliminated. Legislation is required to implement these recommendations, which could materially affect Postal Service financial results beyond FY 2005.

This IFP does not assume any impact of proposed legislation that has been introduced in the House or Senate, either as it relates to CSRS amendments or postal reform.

# INTEGRATED FINANCIAL PLAN

## FISCAL YEAR 2005

### OPERATING PLAN

The operating plan allocates resources to meet established goals and provides cash flow from operations to finance capital investments. In FY 2005, revenue is expected to decline 0.3 percent, and despite cost reductions of approximately \$1.4 billion, expenses will grow 3.9 percent. The result is a net loss of \$192 million.

#### FY 2004 BASELINE ESTIMATES

Using actual data for the first three quarters, FY 2004 volume is projected to increase by 1.4 percent or 2.9 billion pieces over FY 2003. This growth reflects that the economic recovery gained traction at the beginning of the year. In the last half of FY 2004, the rate of economic growth slackened; slower volume growth and revenue declines have followed.

High contribution mail classes, including First-Class Mail and Priority Mail, continue to experience volume declines. First-Class Mail will decline an estimated 1.5 billion pieces or 1.6 percent in FY 2004. This follows a 3.2 percent decline in FY 2003 and marks the third consecutive year of First-Class Mail declines. It appears that the workshare component of First-Class volume also will decline again this year. Single-piece First-Class Mail volume has dropped for six consecutive years. Priority Mail volume will decline an estimated 2.7 percent. Over the last four years, Priority Mail volume has declined over 30 percent. Standard Mail, which has a lower contribution per-piece than First-Class or Priority Mail, was a source of volume growth, projected to increase by an estimated 4.6 billion pieces or 5.1 percent over FY 2003.

Total revenues will decline an estimated \$187 million in FY 2004 from the previous year. The decline in revenue is due to falling volume in high revenue-per-piece mail. Volume growth in Standard Mail will not be enough to offset the revenue losses in First-Class and Priority Mail.

#### FY 2005 REVENUE AND VOLUME

Growth in economic activity, as measured by GDP, began to pick up in 2003 and continued to build in the first calendar quarter of 2004 (quarter 2 of FY 2004). GDP growth slowed in the second calendar quarter (quarter 3 of FY 2004). Based on monthly reports for other economic indicators (e.g., employment, industrial production, personal consumption expenditures) it seems certain that economic growth will also be weaker for the remainder of 2004.

In recent weeks, as the Postal Service was finalizing this operating plan, Global Insight, the principal macroeconomic forecasting service used by the Postal Service, updated its economic forecast and lowered its projection for economic growth. Prior to the forecast update, the target had been to achieve breakeven financial results. However, using the new economic assumptions, the revenue forecast had to be reduced by \$762 million.

Global Insight now expects GDP growth will moderate to an annualized rate of 3.7 percent in FY 2005 from an estimated 4.5 percent in FY 2004.

Economy-wide retail sales, which is an economic indicator for Standard Mail and workshare First-Class Mail, is estimated to grow 4.9 percent in FY 2004 and to slow to 1.8 percent growth in FY 2005. They forecast that the declining rate of retail sales growth is caused by high energy prices (which are diverting consumer expenditures from other goods and services), and the lack of continued stimuli from tax cuts and mortgage refinancing. The FY 2005 retail sales slowdown leads to a lower



projected growth rate for Standard Mail volume (down from 5.1% to 4.0%) and a larger projected decline for workshare First-Class Mail (from -0.9% to -1.9%).

Looking forward, Global Insight expects jobs to grow at a sustained rate of approximately 160,000 per month through the rest of 2004 and extending through mid-2005, which is down from its earlier projection of approximately 200,000 per month. This adjusted rate of projected jobs growth is lower than occurred in January through May, 2004 when job growth averaged 225,000 jobs per month, but is a greater rate of growth than was reported for June and July when job growth averaged 55,000 jobs per month.

**Volume Forecasts and Related Revenue Impacts**

The FY 2005 volume forecast is 0.7 percent growth over estimated FY 2004 volumes. FY 2005 volume growth will be less than FY 2004 volume growth, but mirrors it to the extent that volume growth will be led by Standard Mail. In FY 2005 Standard Mail volume is expected to surpass First-Class mail volume for the first time in history.

<b>Volume</b>				
	FY 2004 Estimate	FY 2005 Plan	Change	%
				Change
First-Class	97,505	95,361	(2,144)	-2.2%
Priority	837	811	(26)	-3.1%
Express	54	54	0	0.0%
Periodicals	9,038	8,825	(213)	-2.4%
Standard Mail	95,062	98,838	3,776	4.0%
Package Services	1,127	1,139	12	1.1%
International	855	883	28	3.3%
Other*	<u>573</u>	<u>565</u>	<u>(8)</u>	-1.4%
Total	205,051	206,476	1,425	0.7%
<i>(Pieces in millions)</i>				
* Postal volume, Mailgrams, and Free Mail for the Blind and Handicapped are included in the Other category				

First-Class Mail volume is expected to decline for the fourth consecutive year, reflecting the continued impact of technological alternatives to mail. Priority Mail volume declines are projected to persist as well, as the market continues to turn to lower priced ground shipment alternatives. Express Mail volume is expected to stabilize after four years of decline, due to competitor price hikes and improved service. Technological and demographic changes are causing declines in Periodicals that are expected to continue. Standard Mail and International Mail volumes are projected to grow again in FY 2005. Standard Mail volume growth has benefited from the telemarketing regulations known as the "Do Not Call" list restrictions, but remains sensitive to the economic climate. The 1.1 percent growth projected in Package Services is the net result of projected increases in both Bound Printed Matter and Media Mail volumes, and volume declines in Parcel Post.

Total revenue is projected to be \$237 million less than estimated FY 2004 revenue. Revenue growth rates by class generally track the volume growth rates, except for Package Services, which grows more slowly due to mix shifts.

<b>Revenue</b>				
	FY 2004	FY 2005		%
	Estimate	Plan	Change	Change
First-Class	\$ 36,268	\$ 35,441	\$ (827)	-2.3%
Priority	4,364	4,235	(129)	-3.0%
Express	851	852	1	0.2%
Periodicals	2,161	2,117	(43)	-2.0%
Standard Mail	17,990	18,783	793	4.4%
Package Services	2,208	2,214	6	0.3%
International	1,702	1,750	48	2.9%
Other*	<u>3,033</u>	<u>2,948</u>	<u>(85)</u>	-1.0%
Total	\$ 68,577	\$ 68,340	\$ (237)	-0.3%
<i>(\$ millions)</i>				
* Mailgrams and Free Mail for the Blind and Handicapped are included in the Other category				

The FY 2005 volumes and revenues are based on estimates of FY 2004 results, which most likely will be somewhat different at yearend.

#### **DELIVERY NETWORK**

The delivery network will increase by 1.6 million new delivery points in FY 2004. The same level of increase is expected in FY 2005. Most of the growth continues to be in deliveries by rural carriers.

<b>Delivery Growth</b>		
	FY 2004	%
	Growth	Change
City Deliveries	580	0.7%
Rural Deliveries	920	2.7%
Highway Contract Route	80	3.5%
Post Office Boxes	<u>60</u>	<u>0.3%</u>
Total	1,640	1.2%
<i>(Deliveries in thousands)</i>		

#### **EXPENSE BY BUDGET CATEGORY**

Total expenses are budgeted at \$68.5 billion in FY 2005, an increase of 3.9 percent above FY 2004 estimated expenses. From 1971 through 1999, annual expense growth was below 4.0 percent only twice. With this plan, expense growth will be less than 4.0 percent in four of the last five years due to continuous gains in productivity. The following table provides expense detail by budget category.

<b>FY 2005 Expenses By Budget Category</b>				
	FY 2004 Estimate	FY 2005 Budget	Change	% Change
Field Operations	\$ 56,771	\$ 58,839	\$ 2,068	3.6%
Corporate Transportation	2,695	2,695	-	0.0%
Headquarters Administrative	1,328	1,357	29	2.2%
Programs/Corporatewide Activities	2,201	2,471	270	12.3%
Servicewide	2,708	2,807	99	3.7%
OIG and PRC	131	138	7	5.3%
Interest	102	225	123	120.6%
Total	\$ 65,936	\$ 68,532	\$ 2,596	3.9%
<i>(\$ millions)</i>				

### ***Field Expense***

Field expenses will increase by a net \$2.1 billion in FY 2005, or 3.6 percent. Most of the increase is in salaries and benefits: contractual increases, cost-of-living adjustments (COLAs), health benefits premium increases, and a government-wide increase in the employer's contribution to the Federal Employees Retirement System (FERS). Fueled largely by rising energy costs, the COLAs scheduled for FY 2005 have the potential to attain levels last seen in the 1970's and 1980's. In FY 2005, total additional COLA expense is estimated to be approximately \$650 million. The growth in field costs is restrained by \$1.2 billion in gross cost reductions. Specifics of cost reductions are presented in *Cost Reduction Initiatives*.

### ***Corporate Transportation Expense***

Corporate transportation expense will be held at FY 2004 levels, despite increased energy costs. To maintain costs at FY 2004 levels, Corporate Transportation management has incorporated a \$100 million cost reduction initiative in its FY 2005 plan.

### ***Headquarters Administrative Expense***

Headquarters administrative expense includes headquarters organizations, field support units, and the Postal Inspection Service. Despite rising health benefits costs, headquarters administrative costs will be held to minimal growth over the FY 2004 estimate. Headquarters units have been assessed \$35 million in administrative cost reductions for FY 2005.

### ***Programs and Corporatewide Activities Expense***

Program and Corporatewide Activities are budgeted at \$2.5 billion in FY 2005, only slightly more than had been planned for FY 2004 (FY 2004 program expenses are expected to end the year below budget). The FY 2005 program plan is a 12.3 percent increase over estimated FY 2004 spending. This reflects both change of scope and expansion of major programs in FY 2005. Despite growth over FY 2004, the headquarters program and corporatewide expense budget for FY 2005 remains 3.9 percent below FY 2000 levels.

Changes to major program budgets in FY 2005 include the following and are listed in the table below.

- The Mail Transportation Equipment (MTE) Service Center (contracted) sites account for the largest program expense. These are sites where MTE is processed, repaired, and stored and then distributed to internal and external customers. Spending in this program declines slightly in FY 2005, however, as a result of a redesigned Material Distribution and Inventory Management System (MDIMS), better demand forecasting, inventory reduction, and order shortage reduction.
- Corporate Advertising is aimed at enhancing revenue growth for Postal Service products and services. Increases in this program are the result of an expanded Fall Mailing Campaign.

- Debit and credit card fees are the merchant fees the Postal Service pays to card companies. Although the Postal Service has negotiated lower transaction fees in recent years, the use of debit and credit cards in postal transactions has been increasing more than 14 percent annually.

<b>FY 2005 Program Spending Major Program Impacts</b>				
Program	FY 2004 Estimate	FY 2005 Budget	Change	% Change
Mail Transport Equipment Service Centers	\$ 244	\$ 241	\$ (3)	-1.2%
Corporate Advertising	94	135	41	43.6%
Debit/Credit Card Fees	111	119	9	7.8%
Network Evolution	15	119	104	682.2%
Mail Transport Equipment	87	118	31	34.9%
Point of Service	133	113	(20)	-14.7%
Stamp Manufacturing	110	100	(10)	-9.1%
Telecommunications/Network Operations	80	89	9	11.3%
Corporate Contact Management	85	89	3	4.1%
Expedited Supplies	85	79	(6)	-7.1%
Advanced Computing Environment	114	77	(37)	-32.5%
All Other Programs (419 Programs)	<u>1,043</u>	<u>1,192</u>	<u>149</u>	<u>14.2%</u>
<b>Total All Programs</b>	<b>\$ 2,201</b>	<b>\$ 2,471</b>	<b>\$ 270</b>	<b>12.3%</b>

(\$ Millions)

- Network Evolution includes the evolution of new network plans, two phases of the Surface Air Support System, and the Plant Equipment Reduction Program. Together, these programs constitute the initiative that is redesigning the mail processing and transportation networks.
- Purchased MTE is a national function that provides central purchase of new rolling containers, sacks, trays, lids, and pallets to contain all classes of mail for processing, transporting, and delivering. Growth in this program in FY 2005 results from two years of deferred purchases.
- The "All Other" includes 419 programs totaling \$1.2 billion for FY 2005. Of these programs, 50 are new for FY 2005 and contribute \$112 million to the total increase of \$149 million for this line. The single largest increase of \$27 million is to provide the consumable items needed (e.g. test cartridges, sterile water, archive bottles and buffers) to perform the biohazard testing for each deployed Biohazard-Detection System.

Returning to the budget category chart:

***Servicewide Expense***

Servicewide expenses are national-level expenses that cannot be isolated and charged to individual operating units and are outside local management control. Rising retiree health benefits costs will increase by \$195 million to \$1.5 billion in FY 2005 and are the primary driver of the increase in this category.

***Office of the Inspector General (OIG) and the Postal Rate Commission (PRC)***

The budgets for the OIG and the PRC are developed by those organizations and are not subject to the control of postal management. In total, their requests mean expenditures will grow 5.3 percent, or \$7 million.

### **Interest**

In FY 2004, estimated interest expense to be paid on debt to the U.S. Treasury's Federal Financing Bank (FFB) is \$15 million. This is a reduction of \$320 million from FY 2003 interest expense and results from the statutory mandate to reduce debt and from the FY 2003 debt restructuring. After refinancing in FY 2003, the Postal Service benefited from the flexibility to repay debt with the cash flows produced by tight expense controls and PL 108-18. The \$5 million planned interest on borrowing for FY 2005, a reduction of \$10 million from FY 2004, is a direct result of lower debt levels (see, *Financing Plan*). Interest paid to the FFB is but one component of total Postal Service interest expense. Capitalized interest and interest on postal obligations to the Civil Service Retirement System (CSRS) are the others. Capitalized interest is the amount of interest incurred during a year that is attributable to the construction of facility projects. Capitalized interest reduces interest expense and increases the book value of the facility being constructed. In FY 2004, capitalized interest is estimated to total \$8 million and CSRS interest totals \$95 million. In the IFP for FY 2005, capitalized interest is negligible and CSRS interest is \$220 million. Summing the three components, interest expense is expected to total \$102 million in FY 2004 and \$225 million in FY 2005.

### **EXPENSE BY COMPONENT**

Examining expense growth by component provides a different perspective on the FY 2005 Operating Plan (see the following chart). Personnel expense, including workers' compensation and all other employee and retiree benefits, is expected to increase by \$1.6 billion, or 3.1 percent.

This growth in personnel compensation expenses is caused by salary and benefits costs increases but not growth in workhours which, in fact, will be reduced by 23 million in FY 2005. The major drivers of the expense increase include COLAs and increases to health benefits costs. Health insurance premiums are assumed to increase by 11 percent for current employees in January, 2005.

<b>FY 2005 Expenses By Component</b>				
	FY 2004	FY 2005		%
	Estimate	Budget	Change	Change
Personnel	\$ 52,163	\$ 53,793	\$ 1,630	3.1%
Non-Personnel	8,722	9,374	652	7.5%
Transportation	4,929	5,120	191	3.9%
Interest & CSRS Liability.	<u>122</u>	<u>245</u>	<u>123</u>	100.8%
Total	\$ 65,936	\$ 68,532	\$ 2,596	3.9%
(\$ millions)				

Non-personnel expenses consist of a wide variety of national, field and headquarters costs. The growth in FY 2005 is primarily due to investments in program initiatives to increase postal volumes, update and improve information technology capabilities, improve customer access and service, and to rationalize administrative support and logistics infrastructures, as described previously. Although growth in corporate transportation will be constrained by an initiative to reduce costs by \$100 million, total transportation costs are expected to grow about \$191 million, all in the surface transportation area. The increase is a result of higher fuel costs and the costs brought about by revised Department of Transportation requirements limiting the number of consecutive hours that drivers may spend behind the wheel.

Interest and CSRS liability consist of interest expense, as described previously, and an estimated \$20 million for the CSRS deferred retirement liability principal for each year.

## CONTINUED WORKHOUR REDUCTIONS

The FY 2005 plan is to reduce workhours by 23 million below the estimated FY 2004 total. This will be the sixth consecutive year that the Postal Service has reduced workhours. Workhours were reduced by 11 million in FY 2000, 23 million in FY 2001, 78 million in FY 2002, and 53 million in FY 2003. It is estimated that in FY 2004, workhours will be reduced by 25 million across all major functions. The FY 2005 workhour reduction target is greater than 10,000 full-time equivalent employees. During these six years, the delivery network was increased by 10.4 million deliveries.

## COST REDUCTION INITIATIVES

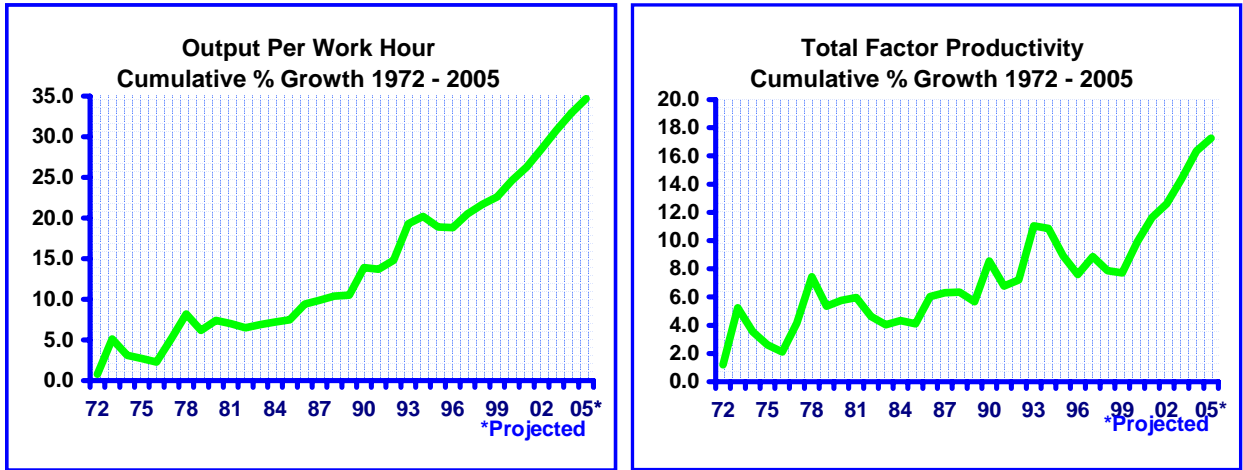
The initiatives which enable the workhour and cost reductions totaling \$1.4 billion in the FY 2005 budget are detailed in the table below. Operational efficiency benefits are spread across all functions, (including transportation and headquarters) employing several programs and productivity initiatives, including Breakthrough Productivity Improvement (BPI) and supply chain management. They total \$1.121 billion in cost reductions. Capital investments will provide cost reductions totaling \$245 million, primarily from automation improvements.

FY 2005 Cost Reduction Overview	
Activity	Savings
Operational Efficiency Gains (Including BPI)*	\$ 986
Network Transportation	100
Headquarters Administration	35
Capital Investments:	
Postal Automated Redirection System (PARS)	\$ 76
Automated Postal Centers (APC)	45
Letter Recognition Enhancement	21
Automated Package Processing System (APPS)	19
Point of Service (POS) One: Stage 3	19
Flats Recognition Improvement	18
Labor Scheduler	18
Flats ID Code Sort	18
All Other	12
Total Reductions From Capital Investments*	\$ 245
Total Cost Reductions	\$ 1,366
(\$ millions)	*Field Cost Reductions

## PRODUCTIVITY

Output Per Workhour measures the change in the relationship between output, or workload (mail volume and deliveries), and the labor resources used in producing those outputs. Total Factor Productivity (TFP) measures the change in relationship between outputs (workload) and all resources used in producing those outputs, including labor, materials, and capital. Output Per Workhour is estimated to increase 2.1 percent and TFP is projected to grow 2.0 percent in FY 2004. This projected TFP growth is equivalent to \$1.3 billion in expense reductions. FY 2004 marks the fifth consecutive year of positive TFP growth, with equivalent expense reductions totaling almost \$6.1 billion over this time period. Productivity growth continues to be fueled by substantial reductions in resource usage. The charts below show the cumulative growth in Output Per Workhour and Total Factor Productivity from the date of Postal Reorganization through the projection for FY 2005. In that time, Output Per Workhour and TFP will have grown 34.7 percent and 17.3 percent, respectively.

Achieving the FY 2005 Integrated Financial Plan will result in a 1.8 percent increase in Output Per Workhour and a 0.9 percent TFP growth rate, a sixth straight year of positive TFP. This is in spite of a small increase in workload (0.7 percent) that is entirely driven by the expanding delivery network.



In previous years of moderate mail volume growth, absorbing the workload made productivity gains easier to achieve. The slower TFP growth rate estimated for FY 2005 is due to earlier achievement of cost reductions (FY 2004 TFP is estimated to be substantially over plan) and stepped up programs to build postal business.

**NET INCOME (LOSS)**

The FY 2005 operating plan results in a net loss of \$192 million.

<b>FY 2005 Operating Budget</b>				
	FY 2004 Estimate	FY 2005 Budget	Change	% Change
Revenue	\$ 68,577	\$ 68,340	\$ (237)	- 0.3%
Expense	<u>65,936</u>	<u>68,532</u>	<u>2,596</u>	3.9%
Net Income (Loss)	\$ 2,641	\$ (192)		
<i>(\$ Millions)</i>				

## CAPITAL INVESTMENT PLAN

### FY 2004 CAPITAL COMMITMENTS

In FY 2004, the capital commitment plan was \$3.2 billion and the year-end estimate is \$1.8 billion. The underrun follows from the delay in three projects. The Postal Automated Redirection System (PARS) phase II for letters and PARS for Flats projects are anticipated to be submitted for Board approval in FY 2005/2006. In addition, the Optical Character Reader (OCR) Enhancement project has been approved but its commitments are split between FY 2004 and FY 2005. This program also benefited from supply chain management initiatives which reduced the anticipated investment. The combination of these three projects, along with some facility delays, account for the majority of the FY 2004 commitment underrun. The OCR project will add capability to existing Advanced Facer Cancellers and remove 646 Multiline Optical Character Readers (MLOCR). It will replace them with 395 Delivery Bar Code Sorter Input Output Subsystems with Expanded Capability (DIOSS EC) and 217 Delivery Bar Code Sorter Input Output Subsystem (DIOSS) Kits to modify existing machines. The Board approved this project in February 2004 with a projected return on investment of 22.5 percent. Other noteworthy projects approved in FY 2004 to be completed in FY 2005 are:

- Restoration of the Trenton, New Jersey Processing and Distribution Center necessitated by the anthrax attack on the facility (approved by the Board in May 2004);
- A new Arlington, Virginia consolidated delivery unit (approved by the Board in June 2004);
- Purchase of Cargo Vans to replace vehicles that have met their expected life span;
- The Human Capital Enterprise system to replace current human resources applications (approved by the Board in May 2004); and
- Continuing financial systems transformation efforts including the Accounts Payable System.

### FY 2005 CAPITAL COMMITMENTS

The FY 2005 capital commitment plan will continue the focus on funding projects that provide a return on investment and address infrastructure requirements. The plan of \$3.3 billion reflects the priorities outlined in the Transformation Plan. The capital commitment plan is set at a level higher than the previous year to allow projects producing positive returns, such as the PARS and OCR Enhancement projects, to be developed and not held back by budget constraints.

FY 2005 Capital Commitments		
	FY 2004 Estimate	FY 2005 Plan
Mail Processing Equipment	\$ 921	\$ 1,852
Facilities	439	1,065
Infrastructure and Support	224	214
Retail	30	26
Vehicles	<u>175</u>	<u>119</u>
Total	\$ 1,789	\$ 3,276
<i>(\$ millions)</i>		



The major categories of the Capital Investment Plan are identified below.

### ***Mail Processing Equipment***

The FY 2005 capital plan for equipment is \$1.9 billion or 57 percent of the total plan. The vast majority of this is for programs that reduce operating costs.

The second phase of Postal Automated Redirection System (PARS) for letter mail is included in the plan to continue the focus on automating processing operations. The PARS program is designed to automate processing of Undeliverable-As-Addressed (UAA) mail and to greatly reduce the number of handlings required to process this mail. PARS is a major cost reduction initiative.

In addition to saving workhours and improving efficiency, automation provides data gathering capabilities that can be used in future information based services. An example is the Intelligent Mail Data Acquisition System (IMDAS) that includes replacing and enhancing the current version of mobile data collection devices (MDCD). The IMDAS will create a standard architecture for receiving data from all types of postal facilities and for modifying and distributing the data to many applications. The program replaces end-of-life handheld devices with new hardware and software technology and also expands the parameters for collecting mail delivery data to provide near real time information on delivery activities.

Continuing the focus on customer and employee safety, the Biohazard Detection System will be attached to the Advanced Facer-Canceller Systems (AFCS) and Flat Cancellers to detect potential biohazards. During AFCS operation, the Biohazard Detection System cabinet collects aerosol samples, tests those samples, and provides a response to the unit's Site Controller.

### ***Facilities***

In FY 2005, the planned commitment for facilities is \$1.1 billion. This portion of the plan reflects an increase in investments for delivery facility infrastructure replacements identified in a national prioritization effort. With an average annual growth of 1.6 million delivery points, the facility infrastructure will be maintained through high priority replacement projects and ongoing repair and alteration projects. Also included in the Facilities category are commitments for major mail processing facilities and enhancements to the processing network.

### ***Infrastructure and Support***

The Infrastructure and Support category is planned at \$214 million. These include investments in information/communications network and system requirements. Examples of the Support Equipment category include the Human Capital Enterprise and Human Resources Shared Services project that replace outdated systems and promote employee self-service, thereby reducing staff in field personnel offices.

The Vehicle Operations Information System will replace obsolete infrastructure and improve data accuracy. This will be accomplished by eliminating manual keying of spare parts and vehicle data. It will enable extensive workload and productivity analysis as well as exception reporting that is not presently supported, and also will allow for detailed identification and analysis of vehicle costs. When fully implemented this system will improve supply chain management performance, improve consignment operations, and enable internal tracking and recovery of warranty items.

The Infrastructure and Support category also includes funds for equipment such as forklifts, scissors lifts, scrubbers, and office equipment.

### ***Retail***

In FY 2005, \$26 million will be committed to retail capabilities. Included in the retail category are additional commitments for the Automated Postal Center (APC) project. APC is a self-service kiosk that offers customers a range of postal products and services.

**Vehicles**

In FY 2005, the planned commitment for vehicles totals \$119 million for the purchase of tractors, trailers, and other support vehicles. In FY 2005 commitments of \$30 million are planned for 2,399 new trailers and \$72 million is planned for 1,823 tractors; these will replace existing equipment that has met its expected life span. Additional commitments include, \$10 million for 362 spotter-tractors (vehicles used to station trailers at platforms and staging areas) and \$7 million for auxiliary vehicle equipment, such as tow-hitches, lift gates and snow removal equipment.

**FY 2005 CAPITAL CASH OUTLAY PLAN**

The FY 2005 plan provides for approximately \$2.0 billion in cash outlays. Approximately \$1.2 billion of the planned outlays in FY 2005 relate to commitments made in prior years. The remaining \$800 million planned cash outlays are for FY 2005 commitments.

<b>FY 2005 Capital Cash Outlays</b>		
	<b>FY 2004 Estimate</b>	<b>FY 2005 Plan</b>
Mail Processing Equipment	\$ 719	\$ 1,195
Facilities	333	515
Infrastructure and Support	160	166
Retail	187	52
Vehicles	<u>123</u>	<u>121</u>
<b>Total</b>	<b>\$ 1,522</b>	<b>\$ 2,049</b>
<i>(\$ millions)</i>		

## FINANCING PLAN

The FY 2004 Integrated Financial Plan (IFP) projected net income of \$2.1 billion, cash flow from operations of \$5.0 billion, and capital outlays of \$2.2 billion. Using the debt repayment flexibility created by \$6 billion debt refinancing in FY 2003, debt was projected to be reduced well beyond the estimated \$2.8 billion required by PL 108-18 legislation. For FY 2004, it was estimated that \$4.2 to \$4.7 billion in debt could be retired, bringing the debt balance to between \$2.6 and \$3.1 billion on September 30, 2004.

<b>FY 2004 Financing Plan</b>		
	IFP FY 2004	Estimate FY 2004
Cash From Operations	\$ 5.0	\$ 5.7
- Capital Cash Outlays	2.2	1.5
- Cash Increase	(1.6) to (2.1)	(1.3)
= Borrowing (Repayment)	(4.2) to (4.7)	(5.5)
Debt Outstanding	\$ 2.6 to \$3.1	\$ 1.8
<i>(\$ Billions)</i>		

The FY 2004 cash flow from operations, assuming a net income of \$2.6 billion, would reach \$5.7 billion. Capital outlays, net of the sale of assets, will be approximately \$1.5 billion. Under these updated projections, debt could be reduced by as much as \$5.5 billion, to an outstanding balance of \$1.8 billion on September 30, 2004. The lower year-end debt level represents a 75 percent decrease from the prior year. Higher than anticipated cash flow from

operations, along with lower than forecasted capital cash outlays, are the drivers of the additional debt reduction. The smaller cash reduction in the new estimate, \$1.3 billion vs. \$1.6 billion, is due to having had a lower cash balance entering FY 2004 than had been projected when the FY 2004 IFP was developed. Total interest expense on borrowings in FY 2004 is expected to be \$15 million, which is \$15 million below the 2004 plan and \$320 million below that of FY 2003.

### **FY 2005 Debt Reduction**

As stated previously, a net loss of \$192 million for FY 2005 is estimated. Under this scenario, cash flow from operations will approximate \$2.8 billion. Capital cash outlays, including emergency preparedness capital outlays, are expected to increase to \$2.0 billion. No net increase in debt is anticipated and the cash available for debt reduction should total \$0.8 billion.

<b>FY 2005 Financing Plan</b>		
	Estimate FY 2004	Plan FY 2005
Cash From Operations	\$ 5.7	\$ 2.8
- Capital Cash Outlays	1.5	2.0
- Cash Increase (Decrease)	(1.3)	0.0
= Borrowing (Repayment)	(5.5)	(0.8)
Debt Outstanding	\$ 1.8	\$ 1.0
<i>(\$ Billions)</i>		

This plan contains risks and uncertainties as discussed in *Risks*. Should risks materialize and uncertainties remain unresolved, it would be prudent to carry a higher cash balance on September 30, 2005, even though it also means a correspondingly higher debt level for one day. Two of the major uncertainties are the disposition of the CSRS escrow account issue and the timing and amount of postal rate increases. Under current law, the Postal Service will be required to place any FY 2006 "savings" attributable to PL 108-18 in an escrow account. The outlook for economic growth and inflation also remain uncertain. Under an unfavorable economic scenario, debt will surely increase.

## SUMMARY

The chart below shows the critical elements of the financial condition of the Postal Service in FY 2004 and FY 2005. The first four lines of this chart reflect the generation of cash from operations as outlined in the Operating Plan. Cash flow from operations is projected to total \$2.8 billion in FY 2005. The next line shows anticipated capital cash outlays. The difference between cash flow from operations and capital cash outlays, net of any planned changes to cash on hand, is the amount needed to borrow, or the amount available to repay debt. The remainder of this chart provides additional information on the Postal Service's financial condition. Debt represents the expected outstanding debt at the end of the fiscal year. The capital commitment plan reports the estimated new capital commitments. The equity amount is the sum of contributions from the federal government and prior years' losses/earnings.

FY 2005 Financial Summary		
	FY 2004 Estimate	FY 2005 Plan
Net Income (Loss)	\$ 2.6	\$ (0.2)
Depreciation	2.3	2.4
Adjustments	<u>0.8</u>	<u>0.6</u>
Cash Flow From Operations	\$ 5.7	\$ 2.8
Capital Cash Outlay	(1.5)	(2.0)
Cash Reductions	<u>1.3</u>	<u>0.0</u>
Debt Repayment	<u>\$ 5.5</u>	<u>\$ 0.8</u>
Debt Outstanding	\$ 1.8	\$ 1.0
Capital Commitment Plan	\$ 1.8	\$ 3.3
Total Equity	\$ 3.5	\$ 3.3
Cumulative Earnings	\$ 0.4	\$ 0.2
<i>(\$ Billions)</i>		

Board Resolution 95-9, concerning restoration of equity and recovery of prior years' losses, established a policy of planning for net incomes that "equal or exceed the cumulative prior years' loss recovery target" set in the last omnibus rate proceeding. Although the Postal Service entered FY 2004 with cumulative unrecovered losses of \$2.2 billion, the projected net Income of \$2.6 billion in FY 2004 means the Postal Service has fully recovered all prior years' losses.

## RISKS

The FY 2005 Integrated Financial Plan is the product of an extensive development process in which numerous scenarios were examined. Management has established a solid foundation for achieving the plan. Aggressive actions to manage expenses in response to the accelerating costs in the past have been successful. However, risk factors in the future must be acknowledged.

### ***Revenue***

Revenue is a function of the amount and mix of mail. As noted, mail volume trends have provided a lower revenue-per-piece mix. If this accelerates beyond what has been projected in this plan, it will have an adverse effect on revenue.

### ***Economic Risk***

Global Insight's baseline economic forecast was used to develop the volume and revenue projections. Global Insight forecasts that economic growth will continue over the next several quarters, with GDP growth remaining strong throughout FY 2005. Retail sales and employment are also expected to continue to grow. Recent monthly economic data, however, show a significant downside risk to economic growth in FY 2005, with many economic indicators posting lower than expected rates of growth.

Risks to a continued economic expansion include inflation accelerating more rapidly than expected due to high energy prices and heavy debt burdens along with rising interest rates that may erode consumers' spending ability.

### ***Inflation***

Inflation has been moderate in recent years. The Consumer Price Index is forecast to stay within its historical range of 2 to 3 percent for FY 2005. As most bargaining employees receive cost-of-living adjustments (COLAs) based on the CPI, inflation has an important impact on Postal Service labor costs. The short-term risk of adverse labor cost variances due to higher than expected inflation is buffered in that the next COLA, scheduled for September 2004 is known. The following COLA, scheduled for March 2005, will affect labor cost for only half the fiscal year.

Rising energy costs are a risk. Oil prices are forecasted to remain over \$40 per barrel for the remainder of FY 2004 and above \$38 per barrel through FY 2005.

### ***Health Benefits Costs***

Health care cost inflation continues to be a significant driver of increased employee compensation costs. The plan for FY 2005 incorporates an expected increase of 11 percent in employee health benefits costs and 15 percent in retiree health benefits costs; the difference is due to additional retirees. The total impact will be greater than \$750 million. The actual impact of premium increases will not be known until plan selections are made in January 2005.

### ***Continued Workhour Reductions***

The FY 2005 operating budget calls for a sixth consecutive year of workhour reductions. Since FY 1999, the Postal Service has accumulated savings of 190 million workhours annually. It is expected that workhours will be reduced by 23 million more in FY 2005. During this same period, over ten million delivery points have been added to the delivery network. Workhour reductions in FY 2005 rely primarily on process improvements, rather than on capital investment programs.

### ***Technology Risks***

The forecasts assume significant diversion of mail volume to technological alternatives in FY 2005 as has occurred in the recent past. An acceleration of diversion would adversely impact financial results.