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

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

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

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

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

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

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Postal Service Board of Governors' Letter, May 15, 2001 To Congress

Board of Governors

UNITED STATES
POSTAL SERVICE

May 15, 2001

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

Dear Mr. Chairman:

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

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

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

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

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

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

Sincerely,

Robert F. Rider
Chairman

Enclosure

FINANCIAL VIABILITY OF UNIVERSAL SERVICE

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

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

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

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

Proposal. Reforms are needed to provide a better opportunity for the Postal Service to manage its business on behalf of the public as nearly as possible in line with market forces, consistent with the preservation of universal service. The Postal Service should have an explicit universal service requirement. This should cover regularly scheduled, daily delivery of letters in all urban and suburban neighborhoods and rural communities throughout the country, at affordable prices. The monopoly provisions necessary to support this universal service requirement should be continued. High-volume routes serving business concentrations and affluent residential areas would be attractive targets for competitors who lack the same universal service responsibilities. For services outside the scope of the universal service requirement, the Postal Service should be expected to manage itself like a business, within a market environment.

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

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

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

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

LABOR AND EMPLOYMENT REFORM

Collective Bargaining

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

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

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

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

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

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

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

Other Employment Reforms

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

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

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

BOARD OF GOVERNORS

UNITED STATES POSTAL SERVICE

May 15, 2001

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

Dear Mr. Chairman:

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

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

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

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

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

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

Sincerely,

Robert F. Rider
Chairman

Enclosure

Testimony of Comptroller General, David Walker, May 15, 2001 before the Senate Committee on Governmental Affairs, Subcommittee on International Security, Proliferation, and Federal Services

United States General Accounting Office

GAO

Testimony

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

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

U.S. POSTAL SERVICE

Financial Outlook and Transformation Challenges

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

G A O
Accountability * Integrity * Reliability

GAO-01-733T

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.

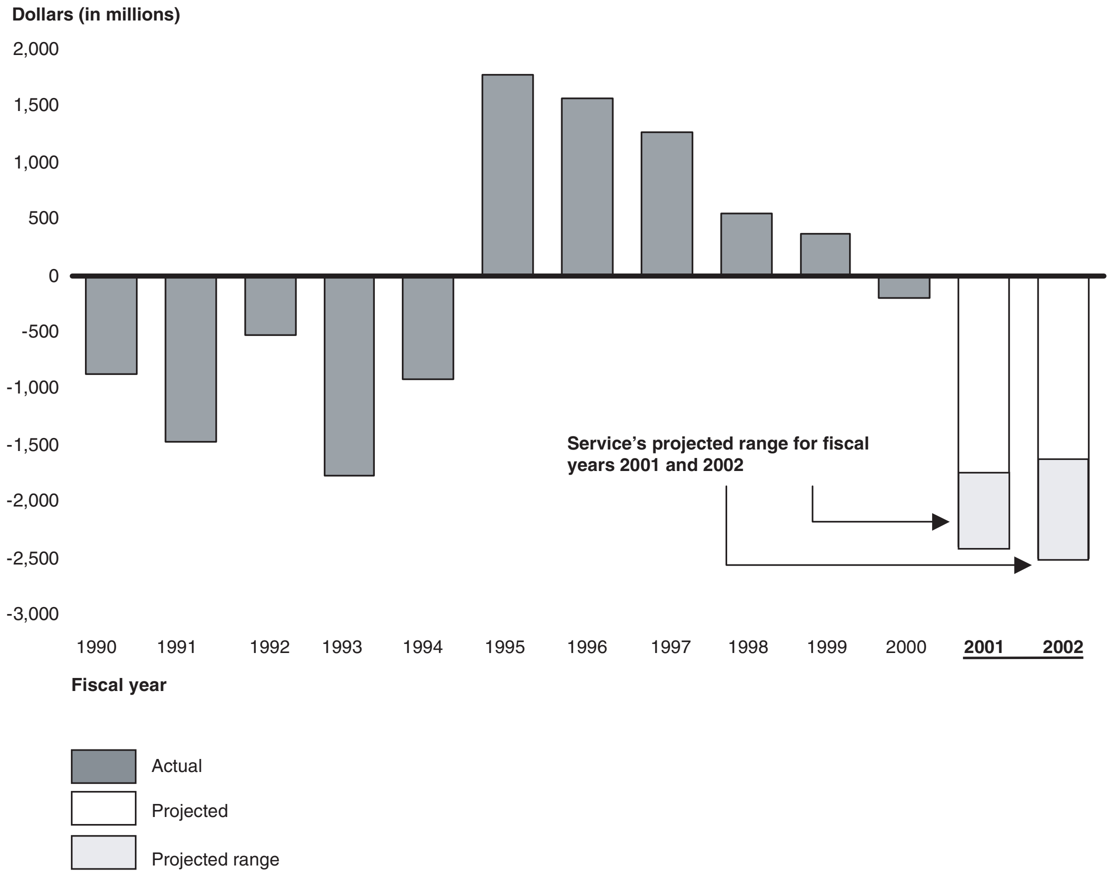
<u>What is the Service's Current Financial Outlook</u>?

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).

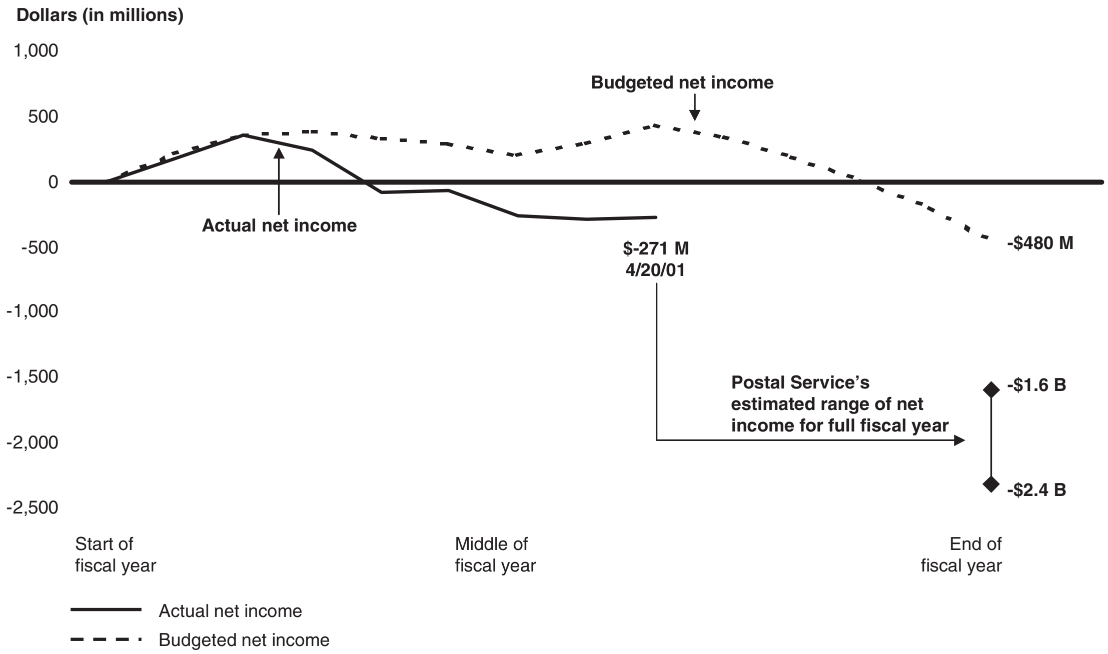
Figure 1: Postal Service Net Income From Fiscal Year 1990 through 2002



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).

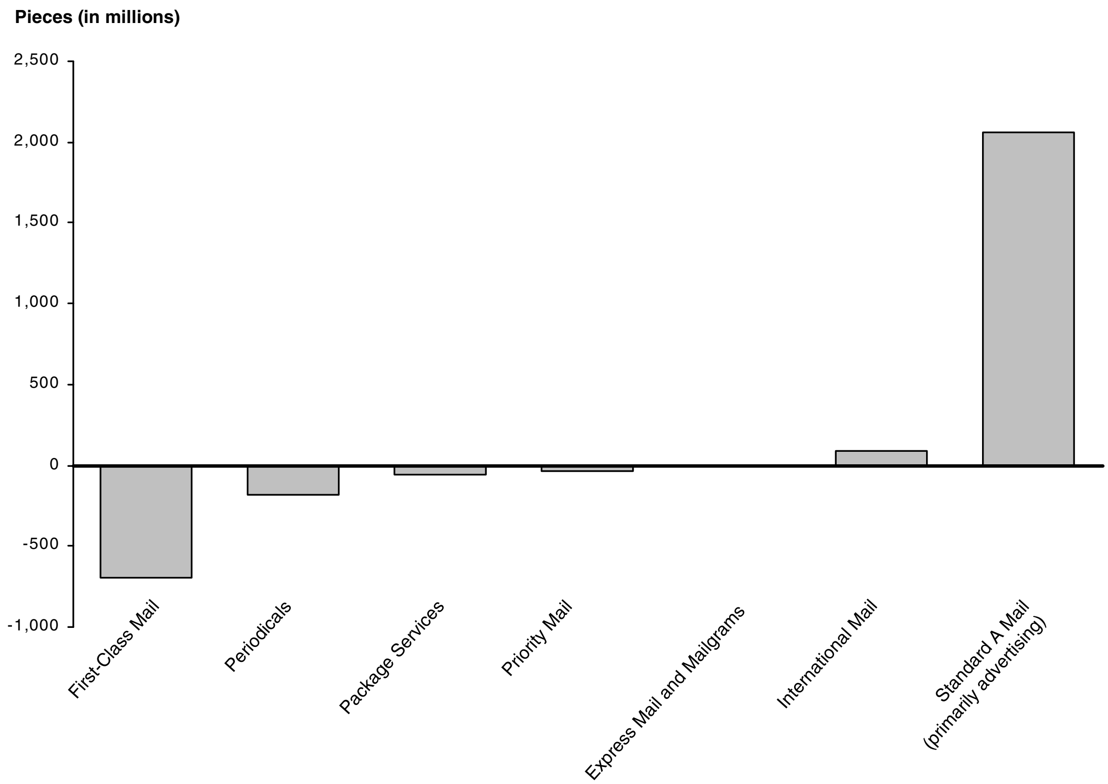
Source: GAO presentation based on U.S. Postal Service estimates, which are subject to change.

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.

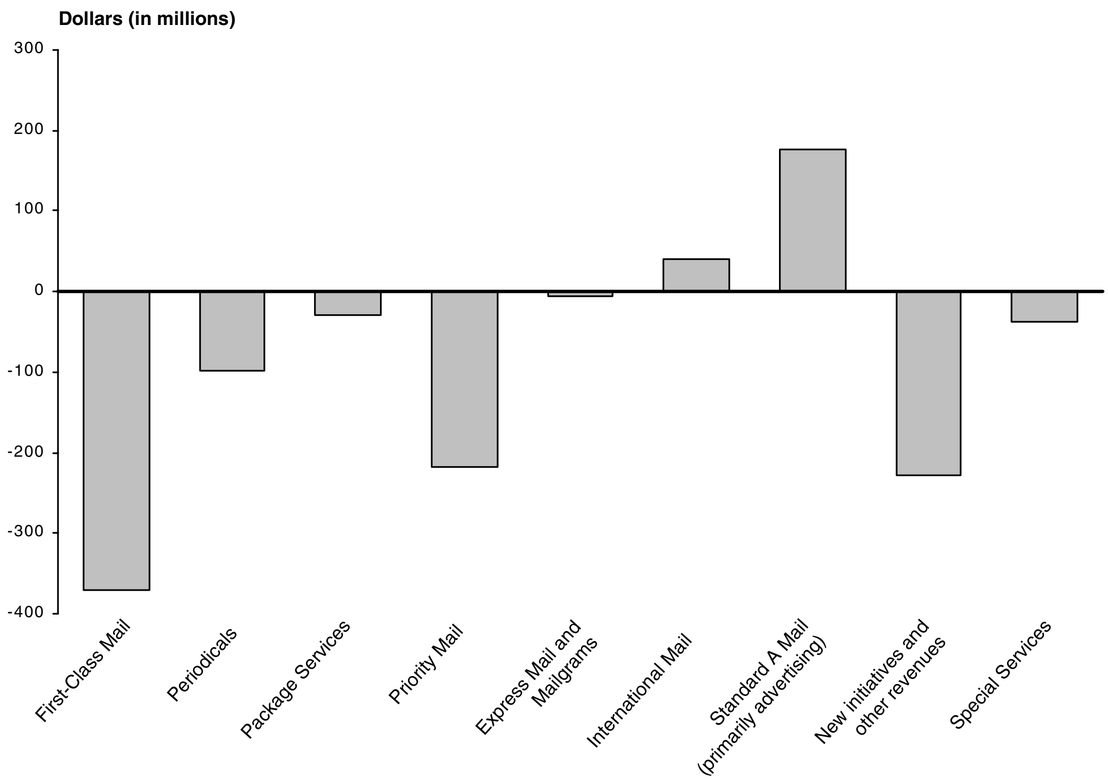
These mail volume shortfalls contributed to the Service's mail revenues being less than budgeted for in the first part of fiscal year 2001. First-Class and Priority Mail, when combined, account for close to two-thirds of the Service's mail revenues and generate revenues that pay for approximately three-quarters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

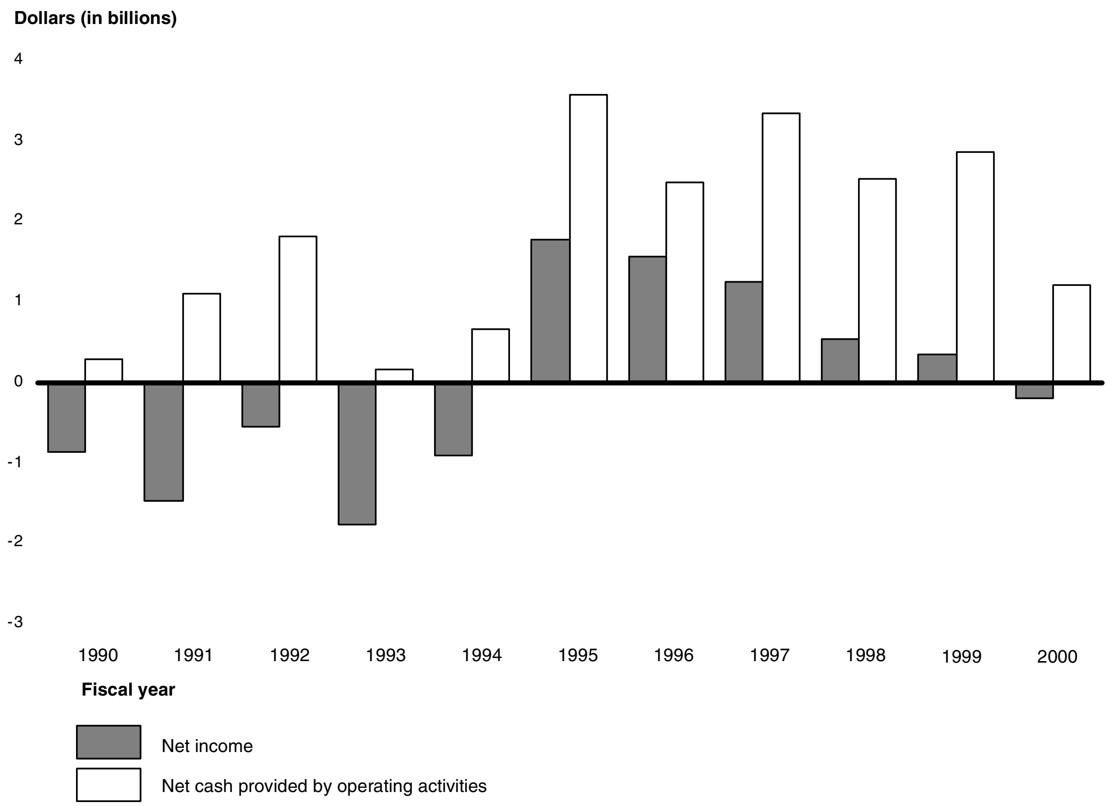
The Service Has Growing Cash Flow and Debt Challenges

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



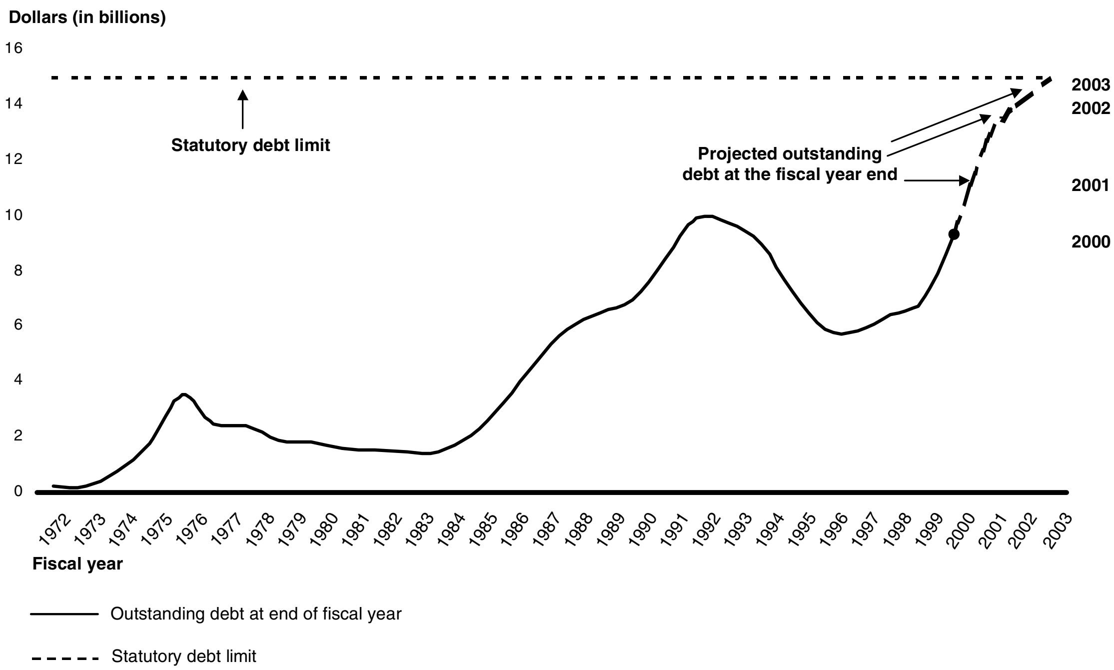
Source: U.S. Postal Service.

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

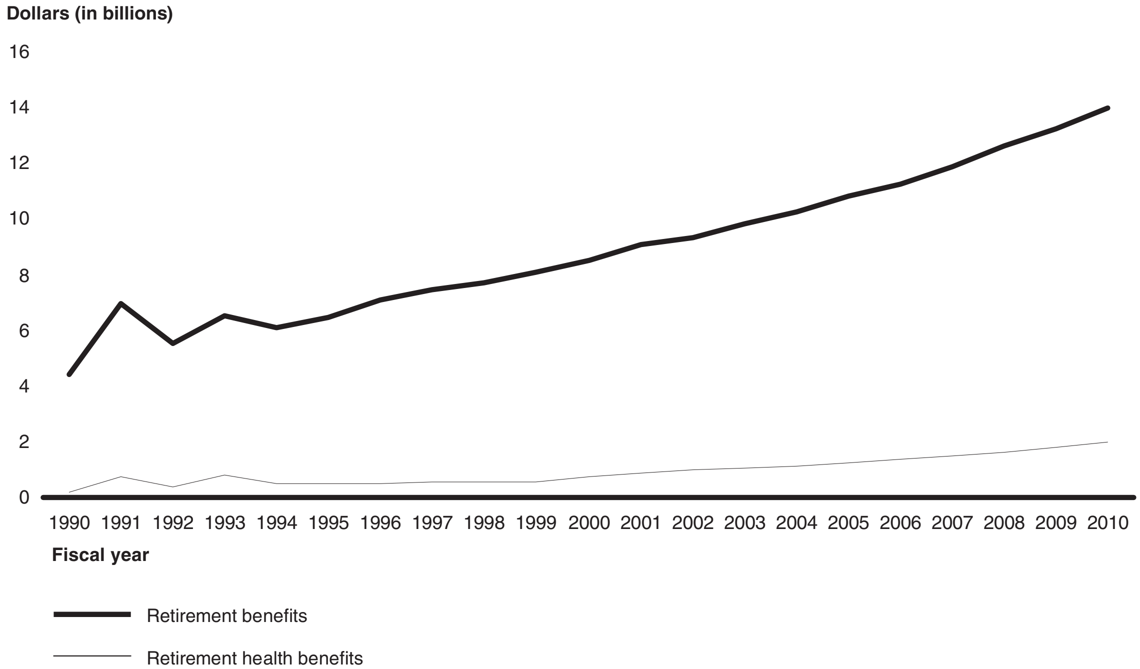


Source: U.S. Postal Service.

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.

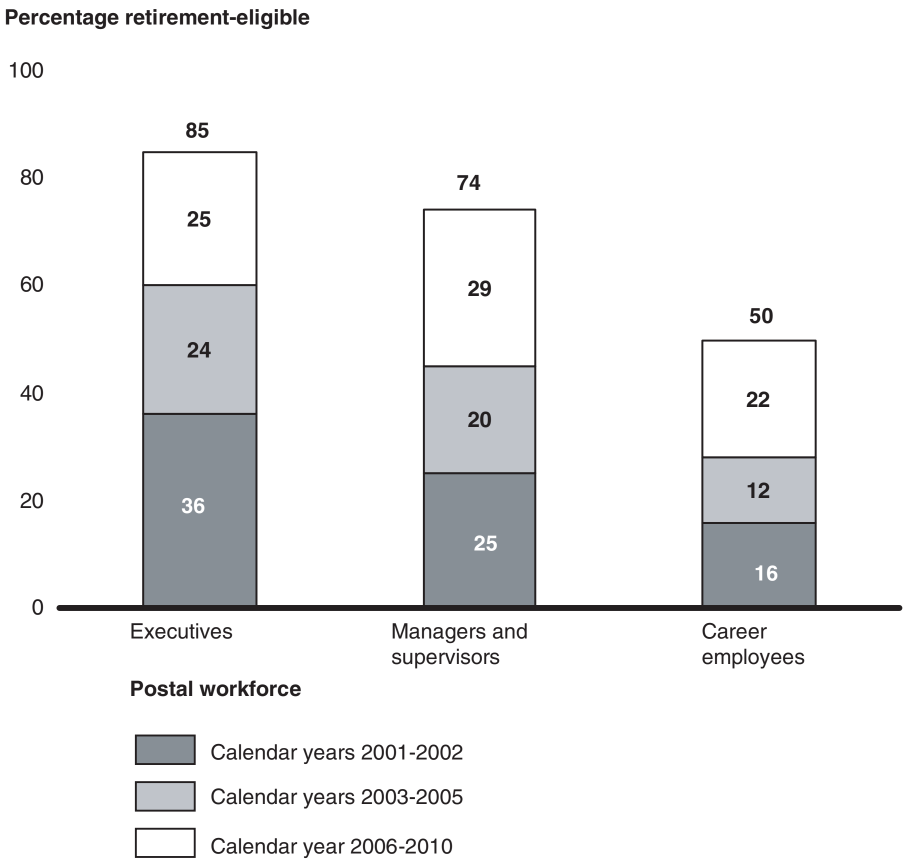
Figure 8: Postal Service Projects Increases in Retirement-Related Expenses



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.

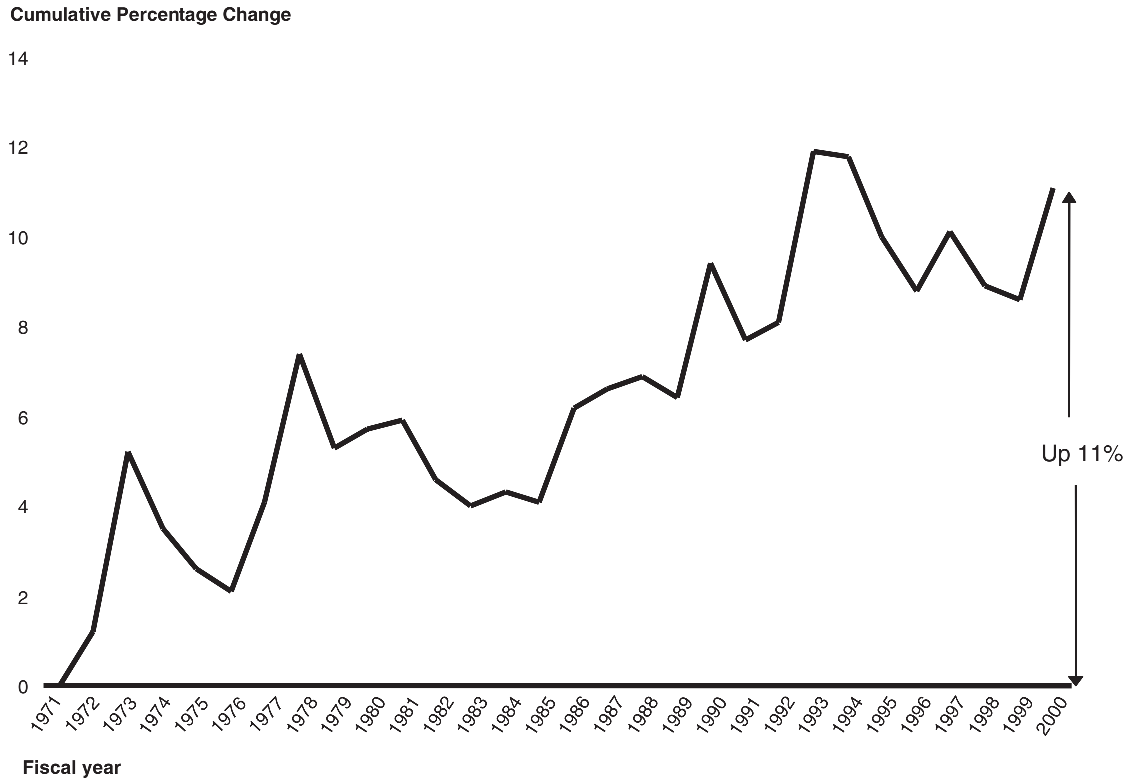
The Service has reported unfunded Civil Service Retirement System retirement liabilities of $32.2 billion at September 30, 2000. These liabilities represent the amount due to the Office of Personnel Management to cover Civil Service Retirement System pay increases and Civil Service Retirement System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