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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

MAIL PROCESSING NETWORK RATIONALIZATION
SERVICE CHANGES, 2012 DOCKET NO. N2012-1

DIRECT TESTIMONY OF STEPHEN MASSE

ON BEHALF OF THE

UNITED STATES POSTAL SERVICE

(USPS-T-2)

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Autobiographical Sketch

My name is Stephen J. Masse. I was appointed Vice President, Finance and Planning, of the United States Postal Service in May 2009, reporting to the Executive Vice President and Chief Financial Officer. I am responsible for all forward-looking financial information, from annual budgets to multi-year financial forecasts. I am also responsible for all revenue and expense budgeting, financial analysis, and program review.

I have twenty-eight years of experience in providing financial management and leadership services to successful business operations. Prior to joining the Postal Service, I served as Vice President, Finance and Operations, at BAE Systems Regional Aircraft, Inc., where I was responsible for business planning, financial reporting, budgeting, and large transaction negotiation and analysis. In nineteen years with BAE Systems, I served in various positions of increasing responsibility, including Controller, Vice President of Finance, and Treasurer. I began my career with Big Four accounting firm KPMG in 1983.

I graduated with distinction from the University of Virginia, receiving a Bachelor of Science degree in Commerce. I am a certified public accountant and have been a member of the American Institute of Certified Public Accountants since 1985.

I. Purpose of Testimony

The purpose of my testimony is to provide the financial context for the proposed Mail Processing Network Rationalization Service Changes initiative. By potentially consolidating over half of the Postal Service's mail processing facilities, the initiative will result in a smaller mail processing network that will make much better use of equipment and facilities when fully implemented. The more efficient network will better align with reduced mail volumes, particularly for First-Class Mail, and will make possible net annualized savings of at least $2.1 billion. As explained in the Direct Testimony of David Williams on Behalf of the United States Postal Service (USPS-T-1), this significant consolidation can only be accomplished by adjusting service standards. In my testimony, I provide the Commission with information on the Postal Service's recent and forecasted mail volume trends and current and expected financial position. Together, these realities have led the Postal Service to conclude that this initiative is necessary and in the long-term interests of all users of the mail.

II. Recent Mail Volumes

The Postal Service depends upon revenues from its products and services to sustain operations and meet its universal service obligation. For decades, steady growth in mail volumes generated revenues that kept pace with increasing costs. Price increases were generally in line with inflation. That growth ended in 2006, when total mail volume peaked at 213 billion pieces.[1] Since 2006, total annual mail volume has fallen by about 45 billion pieces, or

[1] All references to years in this testimony refer to Postal Service fiscal years.

almost 21 percent. In 2009 alone, total mail volume fell 26 billion pieces, or almost 13 percent, the largest annual percentage decline that the Postal Service has experienced since the 1930s.

First-Class Mail volume has declined even more significantly. First-Class Mail peaked in 2001 at nearly 104 billion pieces. Since then, it has fallen by about 30 billion pieces, or 29 percent. The decline in single-piece First-Class Mail has been even more precipitous, falling 52 percent over the same timeframe. Moreover, the rate of volume decline has accelerated significantly in the last five years. The table on the following page illustrates these trends.

	Single-Piece First-Class Mail		First-Class Mail Total	
	Pieces (billions)	Pct Chg	Pieces (billions)	Pct Chg
2001	53.6	-3%	103.7	0%
2002	51.9	-3%	102.4	-1%
2003	49.1	-5%	99.1	-3%
2004	47.7	-3%	97.9	-1%
2005	45.9	-4%	98.1	0%
2006	44.4	-3%	97.6	0%
2007	42.3	-5%	95.9	-2%
2008	35.4	-16%	91.7	-4%
2009	31.6	-11%	83.8	-9%
2010	28.6	-10%	78.2	-7%
2010 recast*	28.9	NM	78.5	NM
2011[2]	25.8	-11%	73.5	-6%
2001 - 2006 avg		-4%		-1%
2007 - 2011 avg		-10%		-6%

- 2010 volumes recast for PRC-approved methodology change.

III. Forecast of Future Mail Volumes

The Postal Service expects mail volumes to continue declining through 2020, with the most dramatic decline continuing to occur in First-Class Mail. The Postal Service expects First-Class Mail volume to decline from 74 billion pieces in 2011 to 39 billion pieces in 2020. This forecast means that, by 2020, the

[2] In August 2011, the PRC approved a new methodology for allocating stamp and meter Postage-in-the-Hands-of-the-Public (PIHOP) to mail classes. At this time, the Postal Service introduced the use of all Point-of-Sale (POS) data in the Revenue, Pieces and Weight report, in lieu of the statistical estimates of mail entered at the retail counter that had previously been used. In order to make 2011 volumes comparable to 2010, the 2010 numbers were restated using the new methodology.

Postal Service will have lost over 60 percent of the annual First-Class Mail volume it had when the Postal Accountability and Enhancement Act of 2006 (PAEA) was signed into law.

The significant loss of First-Class Mail volume is particularly problematic because, of all mail classes, First-Class Mail provides the largest contribution, and, as described by witness Williams (USPS-T-1), it is the class of mail for which the Postal Service's mail processing network was largely designed. In 2010, the latest year for which results are available, First-Class Mail generated two times the revenue and three times the contribution of Standard Mail, the next closest class.

Unfortunately, the Postal Service does not expect First-Class Mail volume to reverse its decline in the foreseeable future. While a strong economic recovery could slow its rate of decline somewhat, the growing use of the Internet and other forms of electronic communication and commerce will likely ensure that the class continues to lose volume each year. And, given that the Postal Service generally cannot increase First-Class Mail prices beyond the Consumer Price Index (CPI) cap, price increases cannot remedy the contribution loss resulting from the First-Class Mail volume loss.[3]

IV. Recent Financial History and Current Financial Position

The volume losses described above, combined with other factors, have led the Postal Service to its current financial position of near-insolvency. The

[3] For example, in 2011, revenue from First-Class Mail was 16.2 percent lower than it was in 2007, in spite of price increases within the CPI cap in May 2008, May 2009, and April 2011.

table below shows that the Postal Service's annual revenues have decreased by over $7 billion since 2006 (the last profitable year), while controllable expenses have decreased by less than $4 billion.

(Dollars, pieces and hours in millions)	2011	2010	2009	2008	2007	2006
Revenues	$ 65,739	$ 67,077	$ 68,116	$ 74,968	$ 74,973	$ 72,817
Expenses	67,927	67,641	69,329	71,949	71,812	71,509
Controllable Operating (Loss) Income	(2,188)	(564)	(1,213)	3,019	3,161	1,308
RHB Pre-funding	-	5,500	1,400	5,600	8,358	-
Workers' Compensation:						
Fair Value Adjustments	978	2,017	718	-	(190)	-
Claims, Admin Fee & Contingency Adjustment	1,901	424	463	225	135	408
Net (Loss) Income	$ (5,067)	$ (8,505)	$ (3,794)	$ (2,806)	$ (5,142)	$ 900
Mail Volume	167,934	170,860	176,744	202,703	212,234	213,138
Work Hours	1,148,837	1,182,947	1,258,025	1,373,354	1,423,001	1,458,729
Career Employees (actual numbers)	557,251	583,908	623,128	663,238	684,762	696,138

The 2011 net loss listed above would have been $5.5 billion greater if Congress had not deferred the required prefunding payment to the Retiree Health Benefits Fund (from September 3, 2011 to November 18, 2011, and later to December 16, 2011). Had the deferral not been enacted, the Postal Service would have been forced to default on that obligation to the government due to a shortage of cash/liquidity.

In 2012, the Postal Service expects a further revenue decline of $1.7 billion. This will translate to a net loss of over $14 billion. Even if the Retiree Health Benefits Fund prefunding obligations were subtracted from this number, the net loss would still be $3.0 billion.[4] Given that the Postal Service has already used $13 billion of its $15 billion statutory maximum borrowing authority, this loss cannot be covered by increasing borrowing.

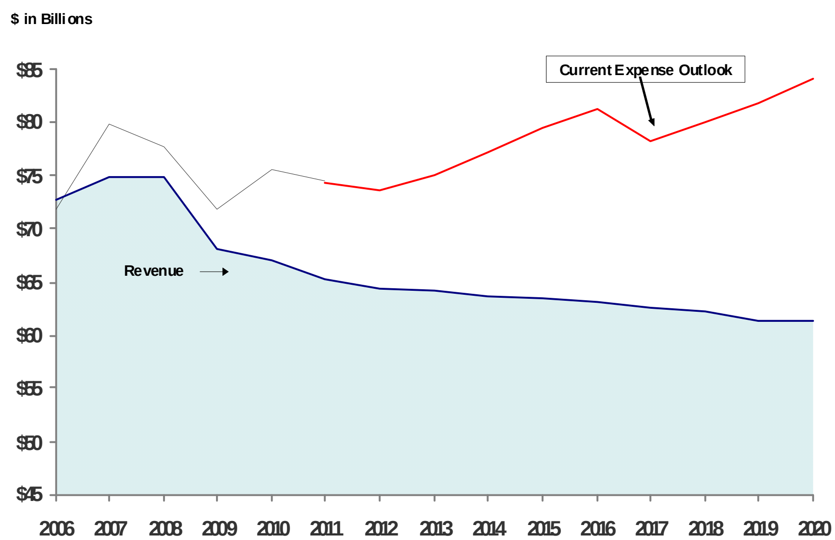
These losses are occurring despite extraordinary cost-reduction efforts. Since 2006, the Postal Service has eliminated 310 million workhours, or 21 percent of the 2006 total. The savings are a result of increased efficiencies from both automation and process improvements. The first three years of this period saw large savings from increased automated processing of letters, flats, and parcels, and the last two years have seen solid reductions from process improvement and Lean Six Sigma reviews. Delivery point sequencing rates for letters continued to improve as additional Delivery Point Barcode Sorters were purchased, and mail forwarding was increasingly automated through the use of the Postal Automated Redirection System. The Flats Sequencing System and the Automated Package Processing System greatly reduced hours in the flats and parcels areas. Additional mail processing savings were achieved through consolidation of tours and facilities. Route reductions have been the key to delivery savings, with joint agreements with the National Association of Letter Carriers allowing the Postal Service to adjust routes more frequently. The net result of these savings has been increased Total Factor Productivity of over 3.5 percent during that time frame.

[4] A Retiree Health Benefits Fund prefunding payment of $5.5 billion is due on December 16, 2011, and another Retiree Health Benefits Fund prefunding payment of $5.6 billion is due on September 30, 2012.

The Postal Service's unprecedented series of annual net losses has led it to take a series of extraordinary measures to provide short-term liquidity. For example, the Postal Service has renegotiated numerous supplier contracts in recent years and dramatically slashed capital investments. Deferrals of prefunding obligations to the Retiree Health Benefits Fund have been sought from Congress and were received in 2009 and 2011. Going even further, in 2011, the Postal Service took the unprecedented step of temporarily suspending its biweekly employer contribution payments to the defined benefits portion of the Federal Employees Retirement System program to create a temporary cash cushion during a traditionally cash-short part of the fiscal year. In spite of these efforts, current financial projections indicate that the Postal Service will be forced to default on the Retiree Health Benefits Fund prefunding payments due on December 16, 2011 and again on September 30, 2012, unless the payments are deferred or rescheduled by legislation.

Unfortunately, the Postal Service's liquidity position continues to worsen, with additional losses projected for 2012 and beyond. Assuming no payment at all on the $11.1 billion of prefunding obligations due to the Retiree Health Benefits Fund in 2012, total cash/liquidity is currently forecasted to be the equivalent of less than three days of operating expenses by September 30, 2012. Additionally, after the annual workers' compensation payment of $1.3 billion to the Department of Labor in October 2012, the Postal Service is forecasted to have only a half-day of cash remaining.

The chart below illustrates the projected trajectories of the Postal Service's revenues and expenses through 2020 under a status quo scenario. To survive, the Postal Service must significantly reduce the current expense outlook by seeking drastic savings and efficiencies in all areas.



[5]

Generating sufficient new revenue to offset the decline in First-Class Mail volume and revenue would be exceedingly challenging. To create a substitute for the $2.6 billion in cost savings that will be generated by the service change initiative under review in this docket would require growth equivalent to more than 11 billion pieces of First-Class Mail, or roughly 16 percent volume growth from 2011 (at a time when such volume has been decreasing by 6 percent annually). It would require doubling the volumes of all competitive postal products.

Likewise, increasing prices significantly to offset the decline in volumes would be insufficient, as it would likely require approximately $5 billion in new revenue, or an eight percent increase over 2011 revenues. To put such an increase in perspective, $5 billion of new revenue is the equivalent of growing an entire Fortune 500 company in one year, from scratch.

To ensure the Postal Service's long-term survival, the expense line must urgently be reduced below the revenue line.

V. Realigning Mail Processing Network with New Volumes

In Section 302 of the PAEA, Congress found that the Postal Service's networks were larger than necessary and directed the Postal Service to consolidate its infrastructure to better align with changing conditions. Since then, the Postal Service has continually pursued operational consolidation opportunities to reduce excess capacity in its networks. Unfortunately, because of the recent sharp volume declines described above, the Postal Service has not been able to realign its processing network to fully reflect the smaller mail volumes. The Government Accountability Office recently remarked about this situation:

> USPS has taken actions to reduce excess capacity and improve operational efficiency throughout its mail processing network for sorting and transporting mail, but has had difficulty comprehensively adjusting its network to respond to the unprecedented mail volume decline since fiscal year 2006. As a result, costly excess capacity remains…. USPS's mail processing network could handle significantly more mail than is currently going through the system…. In order for USPS to be self-sustaining, it needs to significantly reduce its costs to match its revenues. Change is needed to needed to facilitate restructuring postal networks and operations.[5]

[5] Government Accountability Office, *U.S. Postal Service: Dire Financial Outlook and Changing Mail Use Require Network Restructuring*, Report No. GAO-11-759T (June 15, 2011).

The service standard changes that are the subject of the present initiative will facilitate a significant consolidation of the Postal Service's mail processing network. In total, the Postal Service could potentially reduce the number of its processing facilities by approximately half. Even these dramatic changes would only reduce the network to a size consistent with 2010 volumes. In 2011, volume dropped by another 3 billion pieces, or 1.7 percent, and in 2012 volume is forecast to decline by another 10 billion pieces, or 5.9 percent. Although the proposed network rationalization and associated service standard changes would lead to a mail processing network that better aligns with current and future projected mail volumes, additional consolidations may become necessary in the future.

VI. Net Financial Impact of Initiative

Right-sizing the Postal Service's mail processing network, as part of the present initiative, will lead to significant cost savings. The Postal Service estimates that the initiative will make possible annualized cost savings of $2.6 billion.[6] On the other hand, the Postal Service estimates that the initiative could lead to an additional mail volume loss of up to 1.7 percent, or 2.9 billion pieces.[7] As witness Whiteman (USPS-T-12) states, this would translate to an annualized revenue loss of up to $1.3 billion, and an annualized contribution loss of up to $0.5 billion. Subtracting witness Whiteman's annualized contribution loss of $0.5

[6] *See* Direct Testimony of Marc Smith on Behalf of the United States Postal Service (USPS-T-9); Direct Testimony of Michael Bradley on Behalf of the United States Postal Service (USPS-T-10).
[7] *See* Direct Testimony of Greg Whiteman on Behalf of the United States Postal Service (USPS-T-12).

billion from witnesses Smith and Bradley's cumulative annualized cost savings of $2.6 billion results in net annualized savings of $2.1 billion.

While the net annualized savings will take time to be realized fully, and while the Postal Service will incur some limited implementation expenses, the eventual net annualized savings will be instrumental to bringing the expense line shown above down below the revenue line.

VII. Conclusion

As stated above, the Postal Service is currently suffering from excess mail processing capacity. Volume forecasts indicate that, without substantial changes, this situation will only worsen. The present initiative will remove significant excess capacity from the Postal Service's mail processing network, considerably improve the network's efficiency, and better align the network with reduced mail volumes. At the same time, by facilitating at least $2.1 billion of net annualized savings, the initiative will contribute significantly to the Postal Service achieving financial stability.