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U.S. POSTAL SERVICE

Legislation Needed to Address Key Challenges

Statement of Phillip Herr, Director
Physical Infrastructure Issues

U.S. POSTAL SERVICE

Legislation Needed to Address Key Challenges

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Highlights

Highlights of GAO-11-244T, a testimony before the Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

The U.S. Postal Service's (USPS) financial condition and outlook deteriorated sharply during fiscal years 2007 through 2009. USPS actions to cut costs and increase revenues were insufficient to offset declines in mail volume and revenues. Mail volume declined from 213 billion pieces in fiscal year 2006, to 171 billion pieces in fiscal year 2010—or about 20 percent. Volume declines resulted from the recession and changes in the use of mail as transactions and messages continued to shift to electronic alternatives. In this environment, USPS initiatives to increase revenues had limited results.

USPS expects mail volume to decline further to about 150 billion pieces by 2020. This trend exposes weaknesses in USPS's business model, which has relied on growth in mail volume to help cover costs. GAO and others have reported on options for improving USPS's financial condition, including GAO's April 2010 report on USPS's business model (GAO-10-455). Recently, legislation has been introduced that addresses USPS's finances and the need for flexibility to help modernize operations.

This testimony discusses (1) updated information on USPS's financial condition and outlook, (2) the need to modernize and restructure USPS, and (3) key issues that need to be addressed by postal legislation. It is based primarily on GAO's past and ongoing work. In comments on our statement, USPS generally agreed with its accuracy and provided technical comments that were incorporated as appropriate.

View GAO-11-244T or key components. For more information, contact Phillip Herr at (202) 512-2834 or herrp@gao.gov.

What GAO Found

USPS's financial condition continued to decline in fiscal year 2010 and its financial outlook is poor for fiscal year 2011 and the foreseeable future. Key results for fiscal year 2010 included total revenue of $67.1 billion and total expenses of $75.6 billion, resulting in

- a record loss of $8.5 billion—up $4.7 billion from fiscal year 2009,
- a $1.8 billion increase in outstanding debt to the Treasury, thus making the total outstanding debt $12 billion, and
- a $1.2 billion cash balance at the end of the fiscal year.

USPS's budget for fiscal year 2011 projects

- a $6.4 billion loss,
- a $3 billion increase in debt to the $15 billion statutory limit, and
- an end-of-year cash shortfall of $2.7 billion.

USPS has reported achieving close to $13 billion in cost savings in the past 5 fiscal years. However, as its most profitable core product, First-Class Mail, continues to decline, USPS must modernize and restructure to become more efficient, control costs, keep rates affordable, and meet changing customer needs. To do so, USPS needs to become much leaner and more flexible. Key challenges include: changing use of the mail; compensation and benefit costs that are close to 80 percent of total costs; difficulties realigning networks to remove costly excess capacity and improve efficiency; constrained capital investment, which has declined to one of the lowest levels in two decades and led to delays in buying new vehicles; lack of borrowing capacity when USPS reaches its statutory debt limit; and large unfunded financial obligations and liabilities of roughly $100 billion at the end of fiscal year 2010.

Proposed postal legislation, including S. 3831, provides a starting point for addressing key issues facing USPS and facilitating changes, such as rightsizing networks, that will take time to implement and produce results. Also, decisions on postal issues may involve trade-offs related to USPS's role as a federal entity expected to provide universal postal service while being self-financing through businesslike operations. Three key areas addressed by the bill include compensation and benefits; rightsizing USPS networks and workforce; and whether to allow USPS to expand its nonpostal activities. For example, resolving large USPS funding requirements for retiree health benefits is important, while continuing to prefund retiree health benefits to the extent USPS's finances permit. It is equally important to address constraints and legal restrictions, such as those related to closing facilities, so that USPS can take more aggressive action to reduce costs. Allowing USPS to expand into nonpostal activities raises issues of how to mitigate risks associated with new lines of business, assure fair competition with the private sector, and how to finance such efforts. Congress and USPS urgently need to take action to restore USPS's financial viability as business and consumer use of the mail continues to evolve.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to participate in this hearing on proposed legislation[1] to address the U.S. Postal Service's (USPS) challenges to remain self-supporting while providing effective and efficient universal postal service to the nation. My statement will discuss (1) updated information on USPS's financial condition and outlook, (2) the need to modernize and restructure USPS, and (3) key issues that need to be addressed by postal legislation.

This statement is based on our past and ongoing work, including our reviews of USPS's business model,[2] financial condition, networks, service, and postal reform issues. We interviewed USPS officials and reviewed the POST Act of 2010; USPS's audited financial statements for the fiscal year ended September 30, 2010; and other reports, testimonies, and communications on USPS's financial condition, operations, and outlook.[3] We conducted this performance audit in November 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[1]Postal Operations Sustainment and Transformation Act of 2010 (POST Act of 2010), S. 3831, 111th Cong. (2010).

[2]GAO, *U.S. Postal Service: Strategies and Options to Facilitate Progress toward Financial Viability*, GAO-10-455 (Washington, D.C.: Apr. 12, 2010).

[3]Our review included considering information from: USPS audited financial statements and other information in the annual reports for the fiscal year ended September 30, 2010, including the report filed with the Postal Regulatory Commission (PRC) on Form 10-K dated November 15, 2010; USPS quarterly reports filed with the PRC on Form 10-Q for the periods ended June 30, 2010; March 31, 2010; and December 31, 2009; and the USPS Fiscal Year 2011 Integrated Financial Plan.

USPS's Financial Condition Continues to Decline and Its Financial Outlook Is Poor

USPS's financial condition continued to decline over the past fiscal year and its financial outlook is poor for fiscal year 2011 and the foreseeable future. Key USPS results for fiscal year 2010 included a $1.0 billion decline in total revenue to $67.1 billion, and a $3.7 billion increase in total expenses to $75.6 billion, resulting in

- a record loss of about $8.5 billion,
- a $1.8 billion increase in outstanding debt (which left $1.2 billion of available borrowing authority),[4]
- a total of $12 billion in outstanding debt due to the Treasury,[5] and
- a $1.2 billion cash balance at the end of the fiscal year.

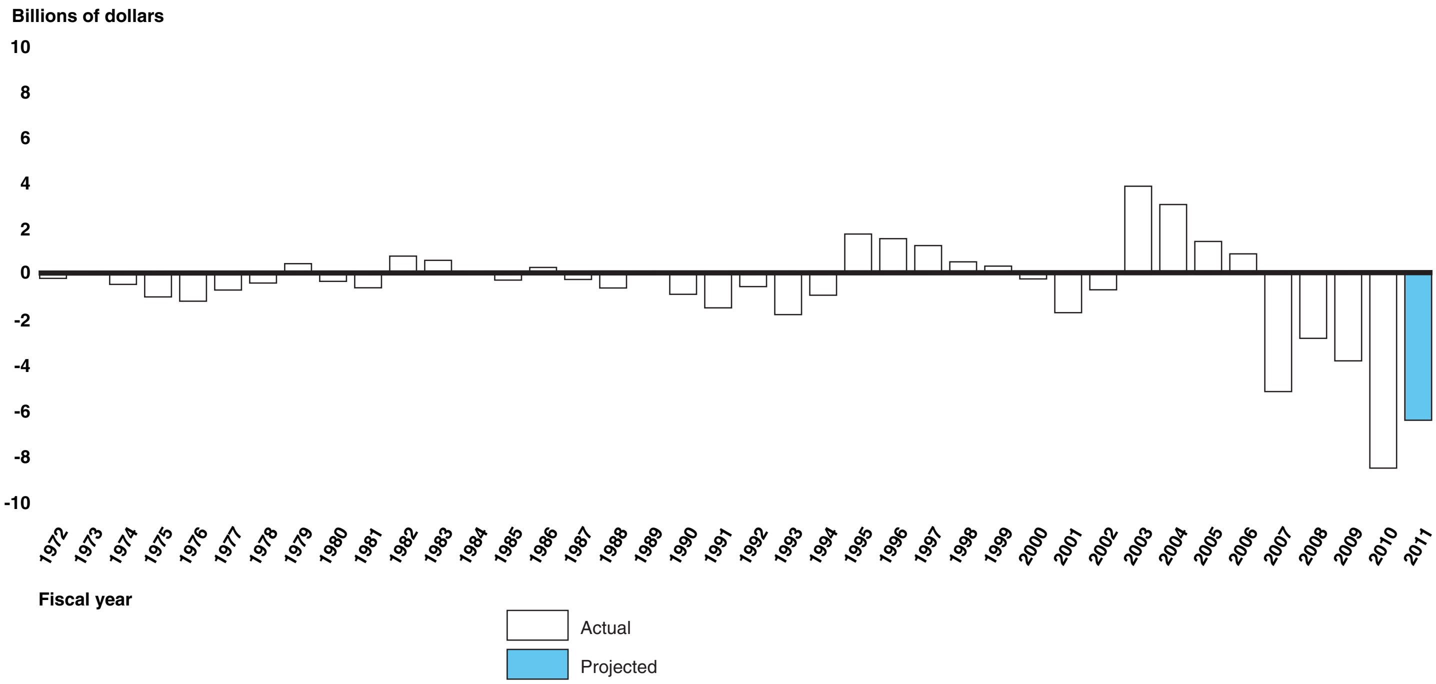
USPS has recently released its budget for fiscal year 2011, projecting

- a $6.4 billion loss (see fig. 1)—one of the largest in USPS history—including the impact of a $5.5 billion payment due in 2011 to prefund retiree health benefits;
- a $3 billion increase in outstanding debt due to the Department of the Treasury (Treasury), thereby reaching its $15 billion statutory limit; and
- a $2.7 billion cash shortfall at the end of the fiscal year.

[4]The statutory limit on annual increases in USPS outstanding debt is $3 billion. 39 U.S.C. § 2005(a).

[5]The statutory limit on total USPS outstanding debt is $15 billion. 39 U.S.C. § 2005(a).

Figure 1: USPS Net Income, Fiscal Years 1972 through 2011



Source: USPS.

USPS's revenue drop in fiscal year 2010 was driven by continuing declines in total mail volume. In fiscal year 2010, mail volume decreased about 6 billion pieces from the previous fiscal year to 171 billion pieces. This volume was about 20 percent below the peak of 213 billion pieces delivered during fiscal year 2006. Most of the volume declines were in profitable First-Class Mail—which were particularly significant because the average piece of First-Class Mail generated about three times the profitability of the average piece of Standard Mail.[6]

USPS currently projects mail volume to increase by about 2 billion pieces in fiscal year 2011. In this fiscal year, First-Class Mail is expected to decrease by 3 billion pieces, but Standard Mail is expected to increase by 5 billion pieces. With these volume changes and expected small rate

[6]First-Class Mail consists of single-piece mail (e.g., bill payments and letters) and bulk mail (e.g., bills, statements, and advertising). Standard Mail is mainly bulk advertising and direct mail solicitations.

increases,[7] USPS projects revenues to increase $0.6 billion in fiscal year 2011.

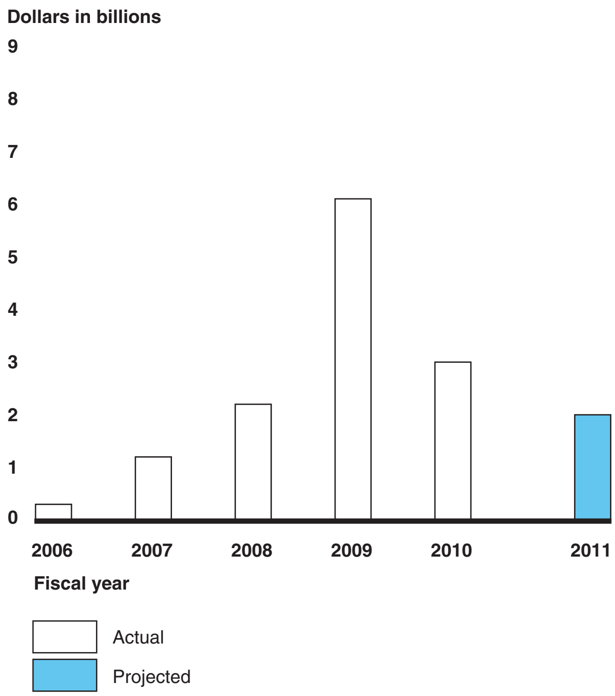
Meanwhile, USPS's expenses increased by $3.7 billion in fiscal year 2010 compared to fiscal year 2009 for several reasons. First, in fiscal year 2010, USPS made its statutorily required payment of $5.5 billion to prefund health benefits for its retirees, in contrast to fiscal year 2009 when Congress deferred all but $1.4 billion of USPS's scheduled payment of $5.4 billion.[8] Second, USPS's workers' compensation costs in fiscal year 2010 were $3.6 billion, up $1.3 billion from the previous fiscal year, primarily from the non-cash effect of changes in the discount rates used to estimate the liability. Third, results of USPS cost savings efforts in fiscal year 2010 were insufficient to offset rising costs in other areas.

According to USPS, it achieved a total of close to $13 billion in cost savings from fiscal years 2006 through 2010 (see fig. 2), primarily by reducing 280 million work hours and its workforce by 131,000 employees. Most savings resulted from attrition, reductions in overtime, and changes in postal operations. USPS reported saving $3 billion in fiscal year 2010, primarily because of a reduction of 75 million work hours—half the savings achieved in fiscal year 2009. Looking forward, USPS projects cost savings of $2 billion in fiscal year 2011, primarily from continued attrition and associated savings.

[7]USPS projects a small average rate increase for market-dominant products by the limit it expects under the inflation-based price cap. These products primarily include First-Class Mail, Standard Mail, Periodicals (mainly magazines and local newspapers), and some types of Package Services (primarily single-piece Parcel Post, Media Mail, library mail, and bound printed matter).

[8]Pub. L. No. 111-68, § 164(a), 123 Stat. 2023 (Oct. 1, 2009).

Figure 2: Cost Savings Reported by USPS, Fiscal Years 2006 through 2011



Source: USPS data.

Further Actions Are Needed to Modernize and Restructure USPS

As its core product—First-Class Mail—continues to decline, USPS must modernize and restructure to become more efficient, control costs, keep rates affordable, and meet changing customer needs. To do so, USPS will need to become much leaner and more flexible. Key challenges include the following:

- *Mail volume and changing use of the mail*: USPS projects mail volume to continue declining to about 150 billion pieces by fiscal year 2020—about 30 percent below its 2006 peak. Most of the declines are projected to be in profitable First-Class Mail. Use of the mail is changing as communications and payments continue to shift to electronic alternatives—a shift that is being facilitated by rapid adoption of broadband. These trends expose weaknesses in USPS's business model, which has relied on volume growth to help cover costs.

- *Postal revenues*: USPS expects revenue to stagnate in the next decade as continued declines in mail volume are offset by rate increases. Rate increases are generally limited by the inflationary price cap on market-dominant products that generate close to 90 percent of USPS revenue.

- *Compensation and benefit costs*: Compensation and benefits, including retiree health benefits and workers' compensation, totaled about $60 billion in fiscal year 2010, or close to 80 percent of USPS costs. USPS pays a higher share of employee health and life insurance premiums than other federal agencies.

- *Difficulties achieving network realignment*: Realigning USPS's mail processing and retail facilities will be crucial for it to achieve sustainable cost reductions and productivity improvements, but limited progress has been made in rightsizing these networks to eliminate costly excess capacity. Although USPS is working to consolidate some mail processing operations, it has closed few large mail processing facilities since 2005. Similarly, its network of post offices and postal retail facilities has remained largely static despite expanded use of retail alternatives and population shifts.

- *Capital investment*: Continuing losses from operations have constrained funds for USPS capital investment. USPS's purchases of capital property and equipment and building improvements have declined in recent years, from $1.8 billion in fiscal year 2009 to $1.4 billion in fiscal year 2010. The deferral of maintenance could impede modernization and efficiency gains from optimizing mail processing, retail, and delivery networks. Further, USPS has delayed buying new delivery vehicles for lack of capital resources. We have an ongoing review of USPS's delivery fleet of about 185,000 vehicles, including about 140,000 long-life vehicles purchased in the late 1980s and early 1990s that are nearing the end of their 24-year expected operating time frame. USPS has estimated replacing its delivery fleet will cost about $5 billion.

- *Lack of borrowing capacity:* USPS expects to increase its outstanding debt to Treasury during fiscal year 2011 by $3 billion, thereby reaching its total statutory debt limit of $15 billion. Even with this debt increase, USPS projects a cash shortfall at the end of this fiscal year. Its cash outlook is uncertain, as indicated by recent experience. USPS reported in August 2010 that it "would likely experience a cash shortfall if legislation similar to that passed in September 2009 is not passed."[9] USPS ended fiscal year 2010 with cash of about $1.2 billion and remaining annual borrowing authority of an additional $1.2 billion, or slightly more than the funds needed for one biweekly payroll. USPS projects it will have insufficient cash at the end of fiscal year 2011 to meet all of its obligations.

- *Large unfunded financial obligations and liabilities*: USPS's unfunded obligations and liabilities were roughly $100 billion at the end of fiscal year 2010. Looking forward, USPS will continue to be challenged by these financial obligations and liabilities, together with expected large financial losses and long-term declines in First-Class Mail volume.

Key Issues Need to Be Addressed by Postal Legislation

Proposed postal legislation, including S. 3831, provides a starting point for considering key issues where congressional decisions are needed to help USPS undertake needed reforms. This bill is based on legislative proposals USPS made this past spring. Resolving large USPS funding requirements for pension and retiree health benefits is important. It is equally important to USPS's future to address constraints and legal restrictions, such as those related to closing facilities, so that USPS can take more aggressive action to reduce costs. Urgent action is needed as some changes, such as rightsizing networks, will take time to implement and produce results. In addition, including incentives and oversight mechanisms would make an important contribution to assuring an appropriate balance between providing USPS with more flexibility and assuring sufficient transparency, oversight, and accountability.

Congressional decisions may involve difficult trade-offs related to USPS's role as a federal entity expected to provide universal mail delivery and ready access to postal retail service while being self-financing through businesslike operations. Future USPS actions and other stakeholder actions are expected to be informed and guided based on congressional decisions related to public policy questions, such as:

- *Benefits*: What changes, if any, should be made to USPS pension and retiree health benefit obligations and payment schedules? What would be the impact on the federal budget?

[9]The September 2009 legislation deferred $4 billion from USPS's statutorily required payment to prefund retiree health benefits, reducing it from $5.4 billion to $1.4 billion. Pub. L. No. 111-68, § 164(a), 123 Stat. 2023 (Oct. 1, 2009).

- *Delivery*: Should the long-standing requirement for Saturday delivery be dropped so USPS can implement its proposal to reduce delivery frequency to 5 days a week? What would be the specific effects on operations, costs, workforce mix, employees, service, competition, the value of mail, mail volume, and revenue? How would shifting to 5-day delivery affect customers including business mailers and the public?

- *Post office closings*: Should USPS have greater flexibility to rightsize its retail networks and workforce, which may involve closing post offices and moving retail services to alternative commercial locations that are often open more days and longer hours than postal facilities? Or should USPS retain its retail facilities and provide new nonpostal products and services?

- *Nonpostal products*: Should USPS be allowed to offer new nonpostal products and services that compete with private-sector firms? If so, how should fair competition be assured? Would it need additional capital for such initiatives? If so, how would they be financed?

- *Processes for change*: What role should Congress, the PRC, USPS, employees, and customers, including business mailers and the public, have in decisions on postal policy issues? What incentives and oversight mechanisms are needed as part of congressional actions to assure an appropriate balance between providing USPS with more flexibility and assuring sufficient transparency, oversight, and accountability?

We have discussed several options that Congress and USPS could consider in a report we issued last April,[10] and are currently conducting a congressionally requested review of USPS's 5-day delivery proposal. In this testimony, we will highlight some options related to three areas that are also addressed by S. 3831—compensation and benefits, rightsizing networks and workforce, and expanding nonpostal activities.

Postal Compensation and Benefits

S. 3831 addresses key retiree health and pension benefit issues. Specifically, it requires OPM to recalculate USPS's CSRS pension obligation in a way expected to make the federal government responsible for a greater share of USPS's CSRS pension obligation. The bill also authorizes the USPS Board of Governors to transfer any part of a resulting

[10] GAO-10-455.

pension surplus to the Postal Service Retiree Health Benefits Fund. The sponsor of S. 3831 has estimated that these legislative changes could result in an increase in the government's pension obligations of approximately $50 billion. Such an increase could impact the federal budget deficit and require funding over time.

USPS has said it cannot afford its required prefunding payments to the retiree health benefit fund on the basis of its significant volume and revenue declines, large losses, debt nearing its limit, and limited cost-cutting opportunities under its current authority. We have reported that Congress should consider providing financial relief to USPS, including modifying its retiree health benefit cost structure in a fiscally responsible manner.[11] Several legislative proposals have been made to defer costs by revising statutory requirements, including extending and revising prefunding payments to the Retiree Health Benefits Fund, with smaller payment amounts in the short term followed by larger amounts later. Deferring some prefunding of these benefits would serve as short-term fiscal relief. However, deferrals also increase the risk that USPS will not be able to make future benefit payments as its core business declines. Therefore, it is important that USPS fund its retiree health benefit obligations—including prefunding these obligations—to the maximum extent that its finances permit. In addition to considering what is affordable and a fair balance of payments between current and future ratepayers, Congress would also have to address the impact of these proposals on the federal budget. Further, the Congressional Budget Office has raised concerns about how aggressive USPS's cost-cutting measures would be if prefunding payments for retiree health care were reduced.[12]

Congress could revisit other aspects of the postal compensation and benefits framework. USPS is required to maintain compensation and benefits comparable to the private sector, a requirement that has been a source of disagreement between USPS and its unions in collective bargaining and binding arbitration. If USPS and its unions go to arbitration, there is no statutory requirement for arbitrators to consider USPS's financial condition. We continue to favor such an arbitration requirement. The law also requires USPS's fringe benefits to be at least as

[11]GAO-10-455.

[12]Congressional Budget Office, *H.R. 22: United States Postal Service Financial Relief Act of 2009* (Washington, D.C.: July 20, 2009); *S. 1507: Postal Service Retiree Health Benefits Funding Reform Act of 2009* (Washington, D.C., Sept. 14, 2009).

favorable as those in effect when the Postal Reorganization Act of 1970[13] was enacted. Career employees participate in federal pension and benefit programs, and USPS covers a higher proportion of its employees' health care and life insurance premiums than most other federal agencies. USPS is also required by law to participate in the federal workers' compensation program, and some benefits paid exceed those provided in the private sector. Furthermore, USPS employees in this program can choose not to retire when they become eligible to retire, and they often decide to remain on the more generous workers' compensation rolls.

Rightsizing USPS's Networks and Workforce

Congressional action is needed to speed USPS's progress in rightsizing its networks and workforce, and S. 3831 seeks to address these issues. Such progress is limited by both stakeholder resistance and statutory requirements. USPS has costly excess capacity and inadequate flexibility to quickly reduce costs in its processing and retail networks. USPS has faced formidable resistance to facility closures and consolidations because of concerns about possible effects on service, employees, and communities, particularly in small towns or rural areas. We have suggested that Congress consider establishing a panel similar to the military Base Realignment and Closure Commissions to facilitate action and progress. Such panels have successfully informed prior difficult restructuring decisions. The panel could consider options for USPS's networks including the following:

- *Mail processing*: Decisions to maintain or close facilities are best made in the context of a comprehensive, integrated approach for optimizing the processing network. Issues include how to inform Congress and the public, address resistance, and ensure employees will be treated fairly. Related issues include whether to relax current delivery standards to enable additional facility closures and associated savings.

- *Retail*: USPS has retained most of its retail facilities in recent years despite the growing use of less costly alternatives to traditional post offices, such as self-service kiosks and stamp sales in grocery stores, drug stores, and over the Internet. USPS has called for statutory changes to facilitate modernizing its retail services.

[13] The Postal Reorganization Act eliminated the Post Office Department and created the United States Postal Service. Pub. L. No. 91-375, 84 Stat. 719 (Aug. 12, 1970).

Expanding USPS Nonpostal Activities

USPS has asked Congress to change the law so it can diversify into nonpostal areas to find new opportunities for revenue growth, and S. 3831 would authorize such action. This could involve USPS entering into new business areas or earning revenues from partners selling nonpostal products at USPS facilities. About 10 years ago, we reported that USPS incurred losses on early electronic commerce and other nonpostal initiatives, and its management of its electronic commerce initiatives was fragmented, with inconsistent implementation and incomplete financial information.[14] Congress then restricted USPS from engaging in new nonpostal activities in the Postal Accountability and Enhancement Act of 2006.[15] Allowing USPS to expand into new nonpostal activities would raise issues about the areas in which it should be allowed to compete with the private sector, how to assure fair competition, how to mitigate risks associated with entering new lines of business, and how to finance such efforts. Related issues could include whether USPS's mission and role as a government entity with a monopoly[16] should be changed, what transparency and accountability would apply, whether USPS would be subject to the same regulatory entities and regulations as its competitors, and whether losses would be borne by postal ratepayers or taxpayers.

A senior USPS official told us that USPS is studying various possibilities for introducing new products and services. A continued issue is whether USPS would make money if it was allowed to compete in new nonpostal areas. USPS has reported that if it could enter such areas, such as banking or sales of consumer goods, its opportunities would be limited by its high cost structure and the relatively light customer traffic of post offices compared with commercial retailers. (There are 600 weekly counter customers at the average post office, compared to 20,000 at the average major supermarket, according to USPS.) USPS has said that the possibility of building a sizable presence in logistics, banking, integrated marketing, and document management was currently not viable because of its net losses, high wage and benefit costs, and limited access to cash to support

[14] GAO, *U.S. Postal Service: Development and Inventory of New Products*, GAO/GGD-99-15 (Washington, D.C.: Nov. 24, 1998); *U.S. Postal Service: Update on E-Commerce Activities and Privacy Protections*, GAO-02-79 (Washington, D.C.: Dec. 21, 2001); *U.S. Postal Service: Postal Activities and Laws Related to Electronic Commerce*, GAO/GGD-00-188 (Washington, D.C.: Sept. 7, 2000).

[15] Pub. L. No. 109-435, 120 Stat. 3198 (Dec. 20, 2006).

[16] USPS has a monopoly over delivery of certain types of letter mail and access to mail boxes.

necessary investment. USPS concluded that building a sizable business in any of these areas would require "time, resources, new capabilities (often with the support of acquisitions or partnerships) and profound alterations to the postal business model."[17]

In summary, the need for postal reform continues as business and consumer use of the mail continues to evolve. Congress and USPS urgently need to reach agreement on a package of actions to restore USPS's financial viability and enable it to begin making necessary changes.

Mr. Chairman, that concludes my prepared statement. I would be pleased to answer any questions that you or other Members of the Subcommittee may have.

Contact and Staff Acknowledgments

For further information about this statement, please contact Phillip Herr at (202) 512-2834 or herrp@gao.gov. Individuals who made key contributions to this statement include Joseph Applebaum, Chief Actuary; Susan Ragland, Director, Financial Management and Assurance; Amy Abramowitz; Teresa Anderson; Joshua Bartzen; Kenneth John; Hannah Laufe; SaraAnn Moessbauer; Robert Owens; Crystal Wesco; and Jarrod West.

[17] United States Postal Service, *Ensuring a Viable Postal Service for America: An Action Plan for the Future* (Washington, D.C., March 2010). This plan is available at the following Web address: http://www.usps.com/strategicplanning/_pdf/ActionPlanfortheFuture_March2010.pdf (accessed on Nov. 23, 2010).

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