United States Government Accountability Office

GAO

Testimony

Before the Committee on Homeland Security and Governmental Affairs, U.S. Senate

For Release on Delivery
Expected at 2:00 p.m. EDT
Thursday, April 14, 2005

U.S. POSTAL SERVICE

Despite Recent Progress, Postal Reform Legislation Is Still Needed

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

GAO
Accountability * Integrity * Reliability

April 14, 2005

G A O

Accountability•Integrity•Reliability

Highlights

Highlights of GAO-05-453T, a testimony before the Senate Committee on Homeland Security and Governmental Affairs

U.S. POSTAL SERVICE

Despite Recent Progress, Postal Reform Legislation Is Still Needed

Why GAO Did This Study

Both the Presidential Commission on the U.S. Postal Service (the Service) and GAO's past work have reported that universal postal service is at risk and that comprehensive postal reform legislation is needed to minimize the risk of a significant taxpayer bailout or dramatic postal rate increases. In April 2001, GAO added the Service's transformation efforts and long-term outlook to its High-Risk List. GAO has testified that comprehensive postal reform legislation is needed to clarify the Service's mission and role; enhance governance, transparency, and accountability; improve regulation of postal rates and oversight; help to ensure the rationalization of the Service's infrastructure and workforce; and make certain human capital reforms.

The Service has made significant progress on some of its key challenges but postal reform legislation continues to be needed in order to facilitate a broader transformation effort.
To help Congress and other stakeholders understand Service progress and the need for postal reform, GAO will focus on (1) Service progress since GAO put Service transformation efforts and long-term outlook on GAO's High-Risk List, (2) why comprehensive postal reform legislation is needed, and (3) key areas for comprehensive postal reform. This testimony is based on an update of GAO's statement to the Committee last year.

www.gao.gov/cgi-bin/getrpt?GAO-05-453T.

To view the full product click on the link above. For more information, contact Katherine Siggerud at (202) 512-2834 or siggerudk@gao.gov.

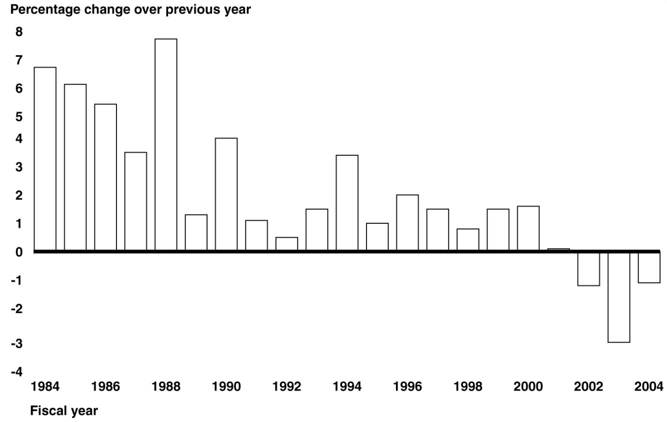
What GAO Found

The Postal Service has made significant progress since its transformation efforts and long-term outlook were added to GAO's High-Risk List in 2001, including achieving record net income, repaying most debt, increasing productivity, and downsizing the postal workforce. However, the Service's financial progress was largely due to a transitory boost provided by 2003 pension reform legislation that reduced the Service's pension costs in fiscal years 2003 through 2005, but also benefited from increased Standard Mail volume and revenues, and certain cost-cutting and efficiency initiatives.

Despite this progress, comprehensive postal reform legislation is needed to address the continuing financial, operational, governance, and human capital challenges that threaten the Service's long-term ability to provide high-quality, universal postal service at affordable rates. The Service's core business of First-Class Mail is declining, squeezing revenues available to help fund universal service costs. Meanwhile, compensation and benefits costs are rising despite workforce downsizing. The Service's financial liabilities and obligations of roughly $70 billion to $80 billion include about $50 billion to $60 billion in unfunded retiree health benefits. Progress is needed to move toward prefunding these benefits, and to increase productivity to offset rising costs, rationalize the Service's infrastructure and workforce, and implement more market-based and performance-oriented compensation systems for all employees. However, progress is hindered by limited flexibility and incentives for success under current law.

First-Class Mail Volume Growth/Decline, Fiscal Years 1984 through 2004

Percentage change over previous year



Source: U.S. Postal Service.

Key elements for postal reform include clarifying the Service's mission and role so that the Service remains focused on universal postal service and competes appropriately; enhancing the Service's flexibility to operate in a businesslike manner with a governance structure suitable for a $70-billion entity, balanced by enhanced transparency, accountability, and oversight; making needed human capital reforms; and moving toward prefunding retiree health benefits.

Chairman Collins, Senator Lieberman, and Members of the Committee:

I am pleased to be here today to participate in this hearing on postal reform. Today, I will focus on (1) the Postal Service (the Service) results since we put its transformation efforts and long-term outlook on our High-Risk List in 2001, (2) the need for comprehensive postal reform, and (3) selected key areas for postal reform. This testimony is an update of our last statement to the Committee.[1] Our bottom line is that the Service has made significant progress since 2001, but its recent financial success was largely due to a transitory boost provided by 2003 pension reform legislation. Comprehensive postal reform is urgently needed because the Service's fundamental transformation challenges continue to exist, thereby placing universal postal service at risk. Because comprehensive postal reform legislation has not been enacted and the Service continues to face formidable, competition, cost and other challenges, its transformation efforts and long-term outlook remain on our High-Risk List. More specifically:

- The Service has made significant progress since fiscal year 2001, including achieving record net income, repaying debt, achieving additional productivity increases, and downsizing the postal workforce.[2] However, most net income was due to a 2003 law[3] that reduced Service pension benefit payments for fiscal years 2003 through 2005. Starting in fiscal year 2006, these "savings"[4] must be set aside in a dedicated escrow account. Under the 2003 law, the Service cannot use the funds in the escrow account unless Congress eliminates the escrow requirement or specifies by law how the escrow funds may be used. Legislative proposals would abolish the escrow and require the Service to begin prefunding existing and future Service obligations for retiree health benefits.

- Comprehensive postal reform legislation continues to be needed to address the fundamental financial, operational, governance, and human

[1]GAO, *U.S. Postal Service: Key Reasons for Postal Reform*, GAO-04-565T (Washington, D.C.: Mar. 23, 2004).

[2]GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005)

[3]The Postal Civil Service Retirement System (CSRS) Funding Reform Act of 2003 (P.L. 108-18) was enacted in response to Office of Personnel Management's finding that the Service was on course to overfund its CSRS obligations.

[4]GAO, *Postal Pension Funding Reform: Issues Related to the Postal Service's Proposed Use of Pension Savings*, GAO-04-238 (Washington, D.C.: Nov. 26, 2003).

capital challenges that continue to threaten the Service's long-term ability to remain self-supporting while providing high-quality, universal postal service at affordable rates. The Service's core business of First-Class Mail continues to decline, squeezing revenues available to pay universal service costs. Meanwhile, compensation and benefits costs continue to rise despite decreases in the number of postal employees. The Service's financial liabilities and obligations of roughly $70 billion to $80 billion are comprised of roughly $50 billion to $60 billion in unfunded retiree health benefits. The current pay-as-you-go approach for these benefits will likely lead to more dramatic and frequent postal rate increases in the future. Progress is needed to move toward prefunding these benefits as well as increasing productivity to offset rising costs, rationalizing and restructuring the outmoded postal infrastructure, rightsizing the postal workforce, and implementing more market-based and performance-oriented compensation systems for all employees. In this regard, progress is hindered by the Service's limited flexibility and incentives for success under current law.

- Key areas for postal reform include clarifying the Service's mission and role so that the Service remains focused on universal postal service and competes appropriately; enhancing the Service's flexibility to operate in a businesslike manner with a governance structure suitable for a $70-billion entity, balanced by enhanced transparency, accountability, and oversight; making needed human capital reforms; and moving toward prefunding retiree health benefits. It is important that Congress act before the Service faces a crisis that could limit congressional options, particularly because it will take time for the Service to implement any major changes.

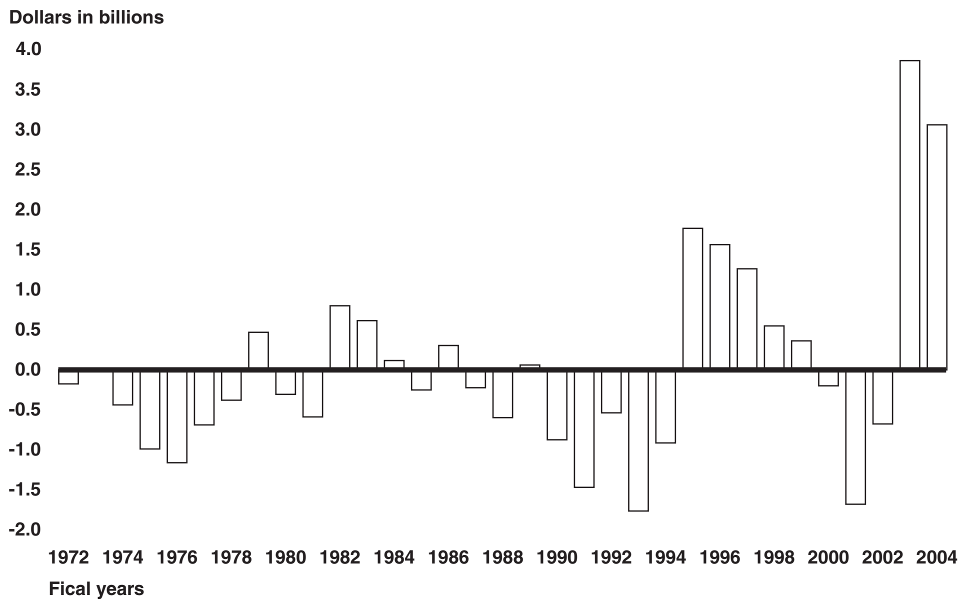
Postal Service Progress

In this section of my testimony, I will highlight significant progress the Service has made since we placed its transformation efforts and long-term outlook on our High-Risk List.

Record Net Income Largely Resulted from Pension Legislation

The Service earned a total of $7 billion in fiscal years 2003 and 2004 combined (see fig. 1) and expects to earn more than $1 billion in fiscal year 2005. However, this net income largely resulted from 2003 legislation that reduced Service pension benefit payments by $6.2 billion in fiscal years 2003 and 2004 combined and $2.8 billion in fiscal year 2005. This legislation has enabled the Service to keep postal rates stable since 2002 and promise not to raise rates until 2006. Absent the 2003 legislation, the Service likely would already have raised postal rates to avoid deficits. Net income also benefited from higher revenues associated with increased volumes of Standard Mail (primarily advertising), as well as certain Service cost-cutting and efficiency initiatives.

Figure 1: Postal Service Net Income, Fiscal Years 1972 through 2004



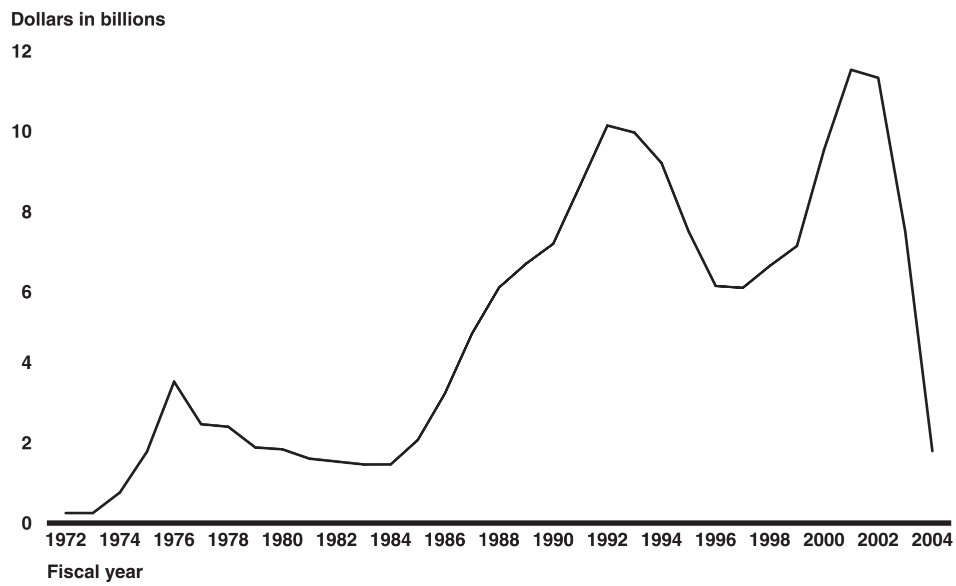
Source: U.S. Postal Service.

The Postal Service Has Repaid Most of Its Debt

Postal Service debt was reduced from a peak of $11.3 billion at the end of fiscal year 2001 to $1.8 billion at end of fiscal year 2004 (see fig. 2). Debt repayment, which has continued in fiscal year 2005, was primarily enabled by pension legislation, previously discussed in this testimony, as well as restraint over capital spending that further reduced the Service's need for borrowing. For example, the Service imposed a temporary freeze on most new capital facility projects in fiscal year 2001 that has since been lifted.[5]

[5]Congress appropriated more than $1 billion to the Service for emergency preparedness funding, including $503 million in December 2004. The Service has requested $51 million in emergency preparedness appropriations for fiscal year 2006.

Figure 2: Postal Service Debt, Fiscal Years 1972 through 2004

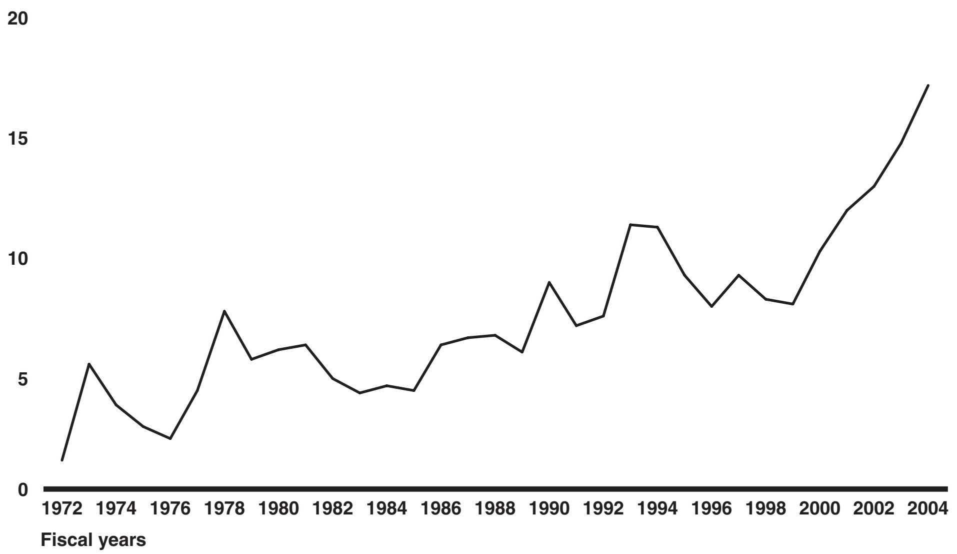


Source: U.S. Postal Service.

Postal Service Productivity Has Continued to Increase

Postal Service productivity increased by 5.2 percent from fiscal years 2001 to 2004, reaching its highest level since fiscal year 1972 (see fig. 3). Productivity rose as a result of many factors, notably cost containment resulting from large reductions in work hours enabled by automation, information technology and other efficiency initiatives; as well as restraint over capital spending.

Figure 3: Cumulative Productivity Growth, Fiscal Years 1972 through 2004



Source: U.S. Postal Service.

The Postal Service Has Downsized Its Workforce

The Postal Service downsized its workforce by 9.4 percent from fiscal years 2001 to 2004; primarily from reductions in the number of career postal employees (see fig. 4). This decline reduced the size of the Service's career workforce to about 707,000 at the end of fiscal year 2004, which was its lowest level since fiscal year 1993. Workforce reductions were made through attrition instead of layoffs, as employees retired and were not replaced, notably in mail processing and administrative functions affected by automation and information technology. Moreover, the number of career letter carriers was also reduced slightly despite a 3 percent increase in the number of delivery points, as more mail was sorted by automation equipment into the order of delivery.

Figure 4: Number of Postal Service Employees, Fiscal Years 1984 through 2004

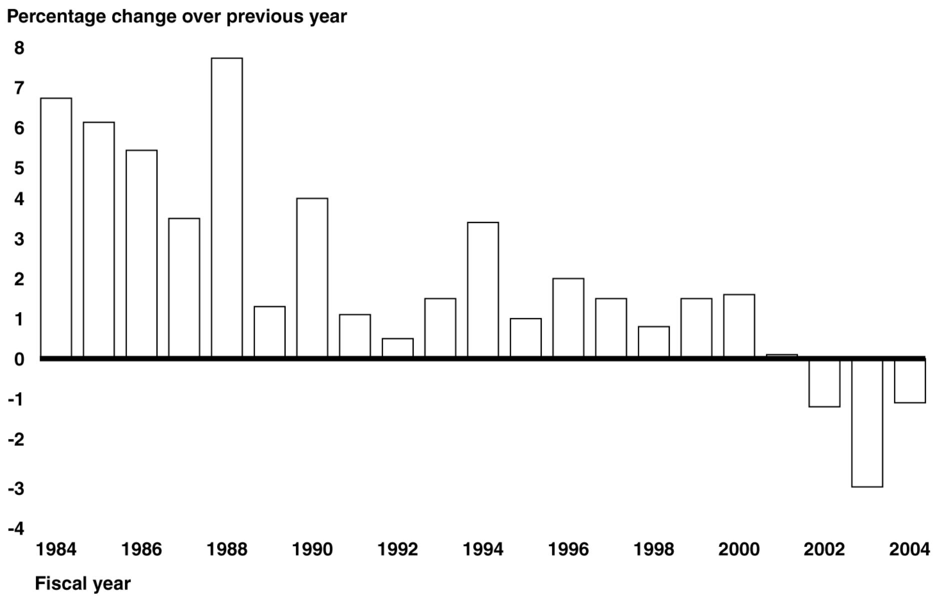
Source: U.S. Postal Service.

The Need for Postal Reform

Key trends and challenges demonstrate the need for postal reform:

Declining First-Class Mail volume: The Service's core business of First-Class Mail volume growth has shown a downward trend since the mid-1980s and declined annually since fiscal year 2001—a first-time occurrence (see fig. 5). This trend is expected to continue for the foreseeable future, as customers continue to increase their use of electronic alternatives for communications and payments.

Figure 5: First-Class Mail Volume Growth/Decline, Fiscal Years 1984 through 2004

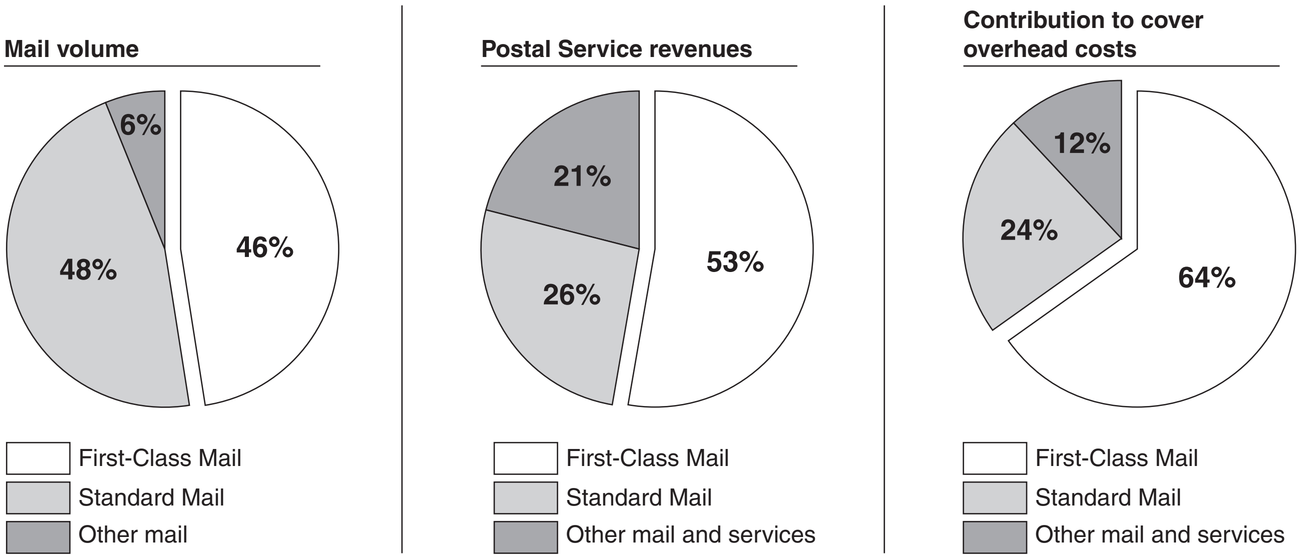


Source: U.S. Postal Service.

Declining First-Class Mail volume poses a fundamental challenge to the Service's long-term viability. First-Class Mail generates about half of the Service's mail volume, more than half of its revenues, and covers more than two-thirds of the Service's overhead costs (see fig. 6). About half of overhead costs, also referred to as institutional costs,[6] are comprised of the universal service costs of maintaining postal delivery and retail networks. Declining First-Class Mail volume is causing a loss of First-Class Mail revenues to cover overhead costs, which will be difficult to recover from other classes of mail.

[6]Institutional costs comprise roughly 40 percent of all postal costs and are defined as costs that are not attributed to specific products and services.

Figure 6: Mail Volume, Revenues, and Contribution to Cover Overhead Costs, Fiscal Year 2004



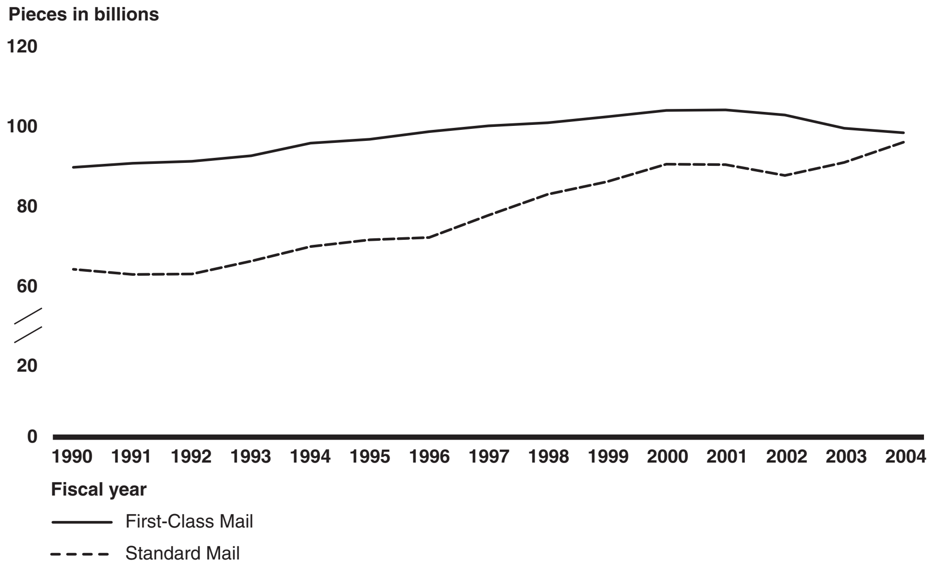
Source: U.S. Postal Service.

Note: Contribution data are the most recent available according to Postal Rate Commission methodology.

[a]Other mail includes mail such as magazines, newspapers, and parcels. Other services include postal services such as post office boxes, money orders, and delivery confirmation.

Changes in the mail mix: The shift in the Service's mail mix from First-Class Mail to Standard Mail has resulted in shrinking revenues to cover overhead costs. Standard Mail volume grew to nearly match First-Class Mail in fiscal year 2004 (see fig. 7) and is expected to exceed First-Class Mail in fiscal year 2005. However, compared with First-Class Mail, the average piece of Standard Mail generates only about half of the revenues and less than 40 percent of the contribution to cover overhead costs.

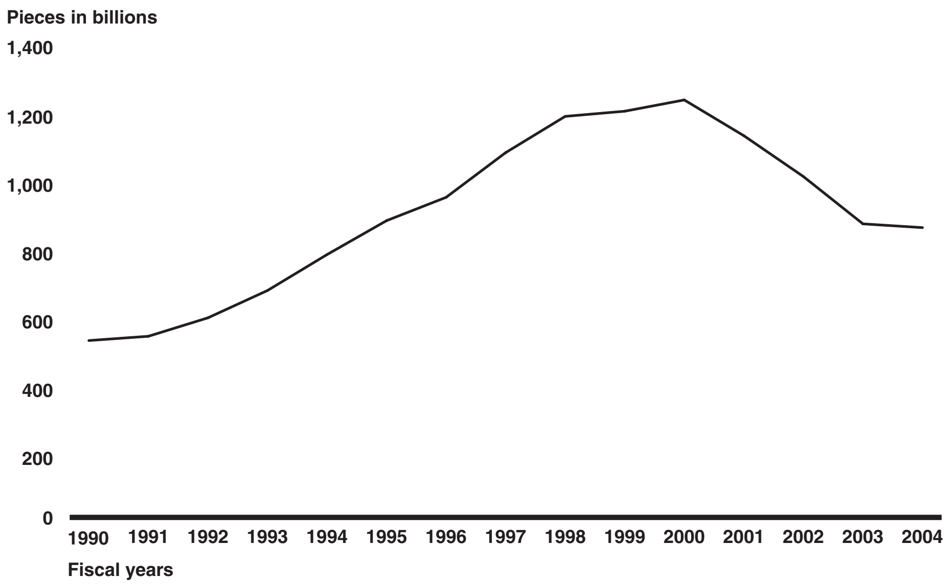
Figure 7: First-Class Mail and Standard Mail Volume, Fiscal Years 1990 through 2004



Source: U.S. Postal Service.

Increased competition from private delivery companies: Private delivery companies dominate the market for parcels over 2 pounds and appear to be making inroads into the market for small parcels. Once a highly profitable growth product for the Service, Priority Mail volume has declined about 30 percent since its volume peaked in fiscal year 2000 (see fig. 8) as the highly competitive parcel market has turned to lower-priced ground shipment alternatives. Express Mail volume has also declined for the same reason. Adding to the competition, United Parcel Service (UPS) and FedEx have established national retail networks through UPS's acquisition of MailBoxes Etc., now called UPS Stores, and FedEx's acquisition of Kinko's.

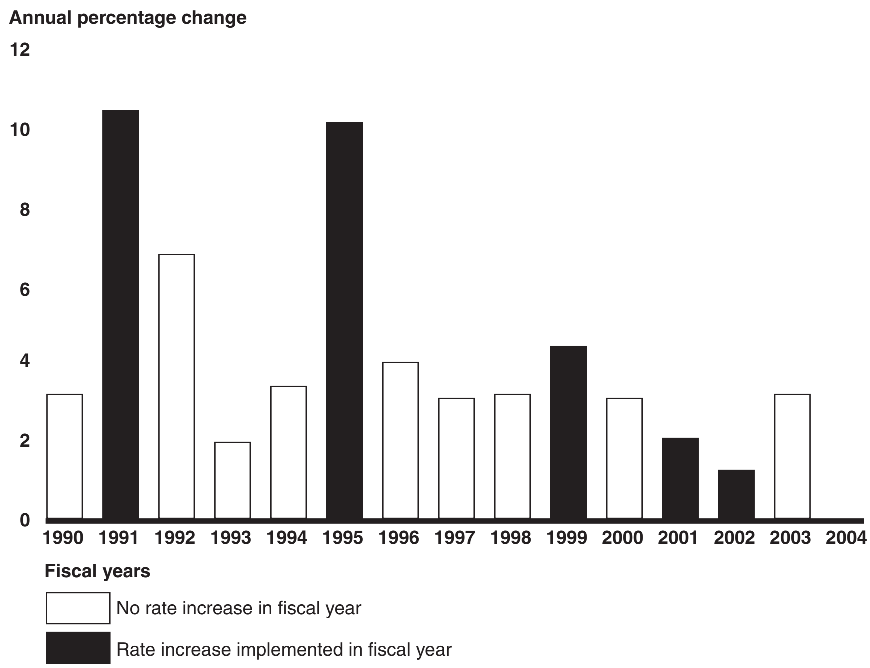
Figure 8: Priority Mail Volume, Fiscal Years 1990 through 2004



Source: U.S. Postal Service.

Subpar revenue growth: Postal revenue growth has slowed in recent years (see fig. 9) due to declining First-Class Mail volume and shifts in the mail mix to lower-margin products. As noted previously, the Service's record net income was largely due to lower pension costs instead of rising mail revenues. If revenues continue to be affected by mail volume trends, that will lead to greater reliance on rate increases to produce needed revenues.

Figure 9: Postal Service Revenue Growth, Fiscal Years 1990 through 2004



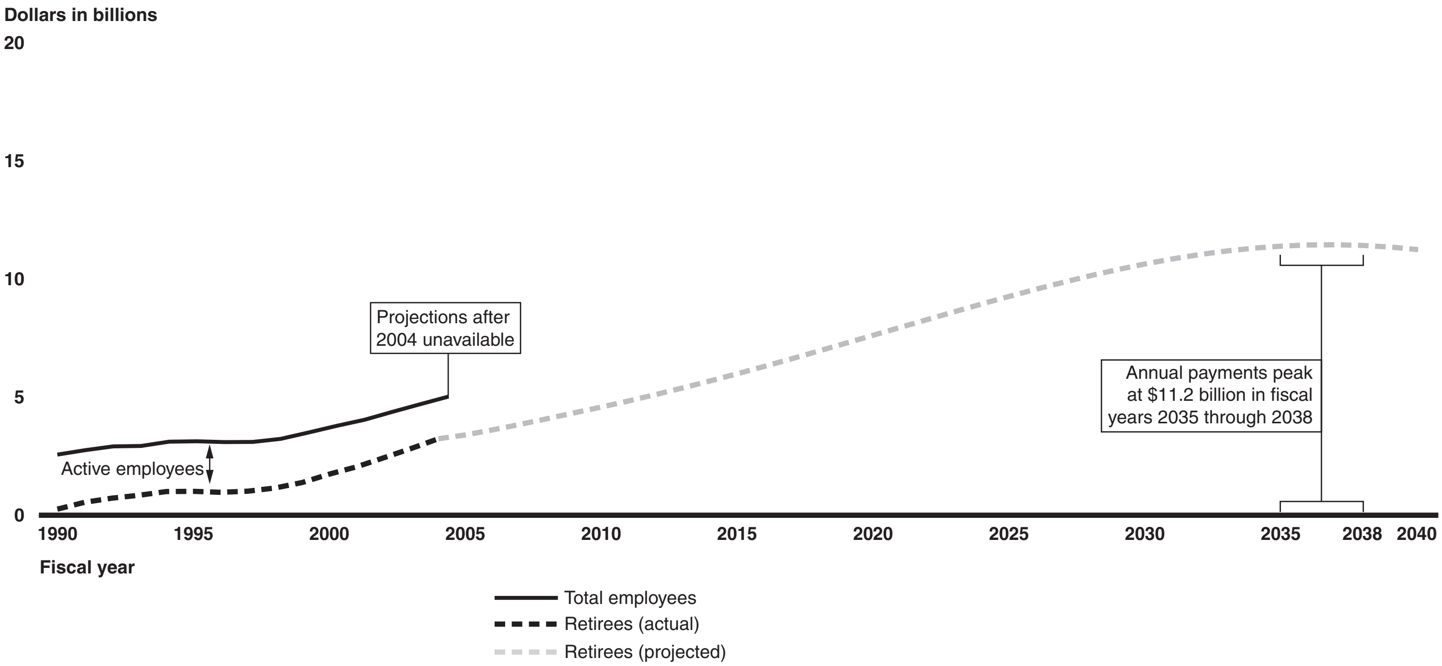
Source: U.S. Postal Service.

Note: Average postal rates increased 19.9 percent in fiscal year 1991, 10.2 percent in fiscal year 1995, 2.8 percent in fiscal year 1999, 6.3 percent in fiscal year 2001, and 7.7 percent in fiscal year 2002.

Rising costs: Key Service costs continue to rise despite continued downsizing and cost-cutting efforts, creating upward pressure on postal rates. In fiscal year 2004, Service compensation and benefit costs increased $1.7 billion, despite a decrease of nearly 22,000 career employees from the prior fiscal year. This cost growth was due to (1) wage increases for craft employees, including cost-of-living adjustments plus basic pay increases; (2) rising benefits costs, including about $500 million in additional health benefits costs for active employees and retirees; and (3) additional workload to serve 1.8 million new delivery points and handle increased Standard Mail volume.

Significant financial liabilities and obligations: The Service estimated it had roughly $70 billion to $80 billion in liabilities and obligations at the end of fiscal year 2004, including roughly $50 billion to $60 billion in unfunded retiree health benefits that were not reported on its balance sheet. Given the Service's workforce demographics and health care trends, its payments for retiree health benefits are projected to rise throughout the next 3 decades (see fig. 10). The Service will have difficulty financing these benefit costs, particularly if unfavorable revenue and cost trends continue.

Figure 10: Postal Service Health Benefits Costs, Fiscal Years 1990 through 2040



Source: U.S. Postal Service.

Note: Projections are based on current law.

Need for substantial improvements in postal productivity: Substantial productivity increases continue to be needed to help keep postal rates affordable, particularly given trends in declining First-Class Mail volume and rising costs. Some productivity increases may result from initiatives to standardize processes among mail processing plants where productivity varies widely. However, it is important to recognize that the current legal framework provides the Service with limited incentives for increasing its productivity. Under the Service's break-even mandate and statutory monopoly to deliver letter mail, no matter how little productivity increases, the Service can raise rates to cover rising costs. However, as postal management has recognized, while raising rates may provide an immediate boost to postal revenues in the short run, raising rates may also accelerate the diversion of First-Class Mail to other alternatives, thus exacerbating the Service's problems in the long run.

Uncertainties regarding postal infrastructure: The Service is using an "evolutionary" approach to develop a more efficient and flexible infrastructure but has disclosed limited information about its overall plans. The Service risks falling short of achieving its goals of rationalizing its infrastructure and workforce and removing excess capacity from its mail processing, distribution, and transportation networks unless it has a clear strategy that includes a comprehensive and integrated plan along with clear criteria as a basis for its decisions, measures to assess the impact of actions taken, and a process for informing key stakeholders, including the Congress.

Key Areas for Postal Reform

Postal reform is needed to address the following key areas:[7]

- *Mission and role*: Congress needs to (1) clarify the Service's mission, because current law has enabled the Service to engage in unprofitable initiatives that are unrelated to its core mission, as well as (2) clarify the Service's role in competing fairly, including its monopoly to deliver letter mail, its authority to regulate the scope of its own monopoly, and other terms of competition.

- *Governance, transparency, and accountability*: Congress needs to (1) delineate public policy, operational, and regulatory responsibilities; (2) ensure managerial accountability through a strong, well-qualified corporate-style board that holds its officers responsible and accountable for achieving real results; and (3) define appropriate reporting mechanisms to enhance the Service's transparency and accountability for financial and performance results.

- *Flexibility and oversight*: Congress needs to balance (1) increased flexibility for the Service to operate in a businesslike manner, through streamlining the rate-setting process and allowing a certain amount of retained earnings, with (2) enhanced oversight by an independent regulatory body to protect postal customers against undue discrimination, restrict cross-subsidies, and ensure due process. In addition, the Service

[7] *U.S. Postal Service: Key Elements of Comprehensive Postal Reform*, GAO-04-397T (Washington, D.C.: Jan. 28, 2004); *U.S. Postal Service: Bold Action Needed to Continue Progress on Postal Transformation*, GAO-04-108T (Washington, D.C.: Nov. 5, 2003).

needs additional flexibility and incentives to rightsize its infrastructure and reshape its workforce. Additional flexibility should be balanced by safeguards to prevent abuse as well as enhanced transparency, accountability, and oversight, starting with appropriate disclosure of the Service's large financial liabilities and obligations.

- *Human capital reforms and pension benefit costs*: Congress needs to consider legislative proposals that would (1) revise the Service's current responsibility for pension costs related to military service, (2) move toward prefunding retiree health benefits, and (3) abolish the escrow account established in recent pension legislation. Congress also needs to decide whether postal workers' compensation benefits should be on par with those in the private sector and to clarify related pay comparability standards. In any event, progress continues to be needed toward flexible, contemporary, performance-oriented, and market-based compensation systems for all Service employees, consistent with proven approaches to strategic human capital management.

Chairman Collins, this concludes my prepared statement. I would be pleased to respond to any questions that you or the Members of the Committee may have.

Contact and Acknowledgments

For further information regarding this statement, please contact Katherine Siggerud, Director, Physical Infrastructure Issues at (202) 512-2834 or at siggerudk@gao.gov. Individuals making key contributions to this statement included Teresa Anderson, Kenneth E. John, Shirley Abel, Kevin Bailey, Gerald P. Barnes, Nancy Boardman, Linda Calbom, Margaret Cigno, Kathleen A. Gilhooly, Donna Leiss, and Laura Shumway.

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone:	Voice:	(202) 512-6000
	TDD:	(202) 512-2537
	Fax:	(202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Paul Anderson, Managing Director, AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548