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U.S. POSTAL SERVICE

Transformation Challenges Present Significant Risks

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





GAO-01-598T

Mr. Chairman and Members of the Committee:

We are pleased to be here today to participate in the Committee's hearing on 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. In my testimony, I will briefly review the Service's growing financial, operational, and human capital challenges in an increasingly competitive environment; discuss the Service's financial outlook; and make suggestions on what needs to be done to address the challenges facing the Service.

The Service's projected financial losses have increased significantly during the past 4 months. Over the past 2 years we have raised concerns about a range of financial, operational, and 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. Moreover, the Service's financial outlook has worsened more quickly than expected, and it is not clear how the Service will address its mounting financial difficulties and other challenges. These challenges include:

- The Service's net income has declined over the past 5 years, and the Service currently projects a fiscal year 2001 deficit in the $2 billion to $3 billion range, up from a projected loss of $480 million just 4 months ago. About $1.8 billion in projected losses are based on results for the first 2 quarters and revised estimates for losses in the last 2 quarters of fiscal year 2001. Based upon its judgment, the Service is also projecting that the slowing economy will further lower net income by $300 million to $1.3 billion. Further, in fiscal year 2002, the Service estimates that its deficit will be in the $2.5 billion to $3.5 billion range, assuming no further increases to postal rates.
- The Service has experienced a net increase in outstanding debt at the end of each fiscal year since 1997, and its total outstanding debt reached $9.3 billion at the end of fiscal year 2000. Service officials expect the Service could reach its $15 billion statutory debt limit by the end of fiscal year 2002, assuming no additional increases in postal rates. At the same time, the Service has curtailed capital investment to conserve cash in fiscal year 2001. In addition, the Service has no plan to reduce its debt. Depending on future events, the Service may face a cash shortage in fiscal years 2002 and/or 2003.
- The Service faces increasing competition from both domestic and foreign-based entities. It also expects electronic diversion—such as greater use of the Internet—to cause substantial declines in First-Class Mail volume in the next decade and thus place the Service under "extreme financial pressure."
- Although the Service has taken steps and plans to cut costs by $2.5 billion by 2003, increase productivity, and improve human capital programs, it has historically had great difficulty achieving desired results in these areas. For example, numerous reports, including some by us and the Postal Service Office of Inspector General (OIG), have noted inefficiencies in the postal system and difficulties the Service has had in realizing opportunities for savings.
- 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. In addition, the Postal Service and the Postal Rate Commission have had longstanding disagreements concerning pricing decisions.

- The Service is subject to several statutory and other restrictions that serve to limit its transformational efforts (e.g., binding arbitration requirement, a cost-based rate-setting process, and facility closure restrictions).
- 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.)

We believe that the Service's deteriorating financial situation calls for prompt, aggressive action, particularly in the areas of cutting costs and improving productivity. Accordingly, we are adding the Postal Service's transformational efforts and long-term outlook to our High-Risk List, effective immediately, so that we and others can focus on its financial, operational, and human capital challenges before the situation escalates into a crisis where the options for action may be more limited. In this regard, we believe the following actions need to be taken:

- The Service should develop a comprehensive plan, in conjunction with Congress and other stakeholders, such as the postal unions and management associations, customers, and the Postal Rate Commission, that would identify the actions needed to address the Service's financial, operational, and human capital challenges and establish a timeframe and specify key milestones for achieving positive results.

- The Service should 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.

- GAO will work with Congress and the Service to help identify improvement options and will continue to analyze and report to Congress on the Service's ongoing financial condition. In consultation with other postal stakeholders including the Postal Service Office of Inspector General, postal unions and management associations, the Postal Rate Commission, and customers, we will review the Service's financial results and future outlook, progress on cost-cutting and productivity efforts, other countries' experiences, and options for addressing the Service's short-term and long-term challenges.

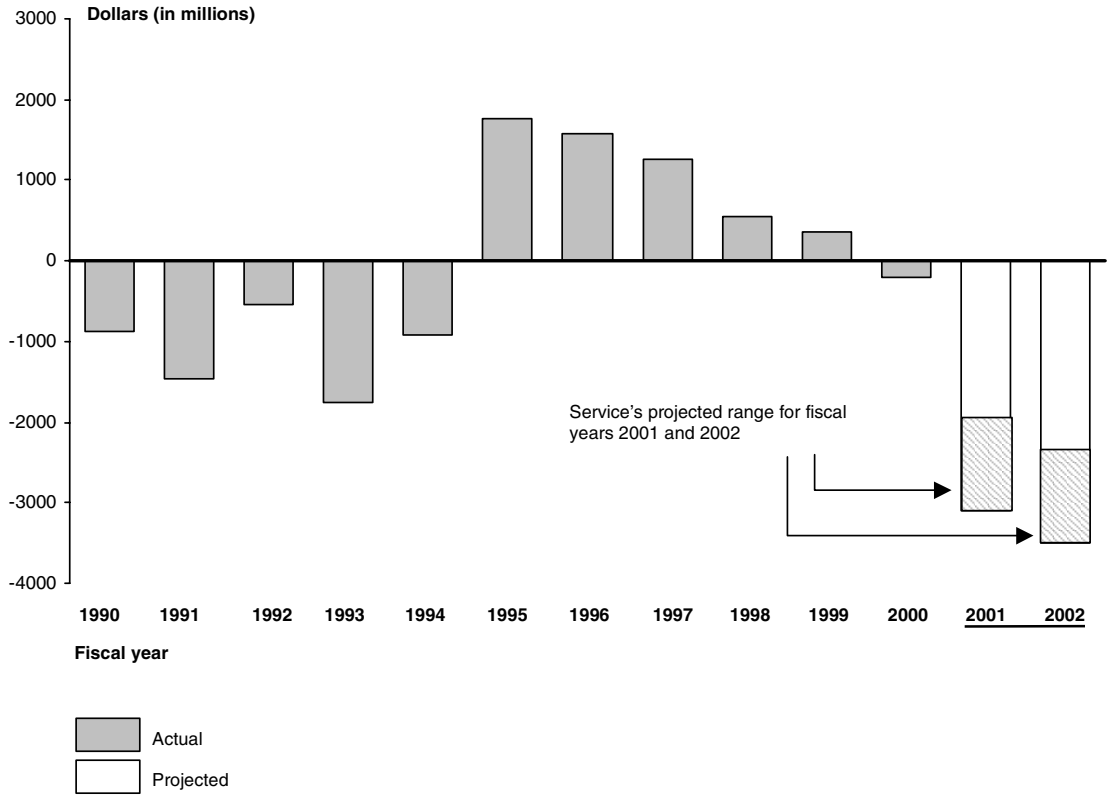
Historical Perspective on the Service's Financial Outlook

The $2 billion to $3 billion deficits estimated by the Service would be unprecedented, although the Service did experience financial difficulties in the early 1990s. The Service's financial position in the early 1990s was adversely affected by the 1990-1991 recession. Also, in 1990, legislation made the Service responsible for funding all health benefits and COLAs for its retirees since July 1, 1971. The Service reported that its financial turnaround in the mid-1990s was aided by rising mail volume, a rate increase that averaged approximately 10 percent in 1995, and a "moderate" increase in expenses. In addition, in the late 1990s, the Service improved the timely delivery of First-Class Mail.

As figure 1 shows, the Service's financial turnaround occurred in fiscal year 1995. The Service raised the price of the First-Class stamp from 29 cents to 32 cents on January 1, 1995. The Service's net income has declined in every year since fiscal year 1995 despite general rate

increases that raised the First-Class stamp price to 33 cents on January 10, 1999, and to 34 cents on January 7, 2001.

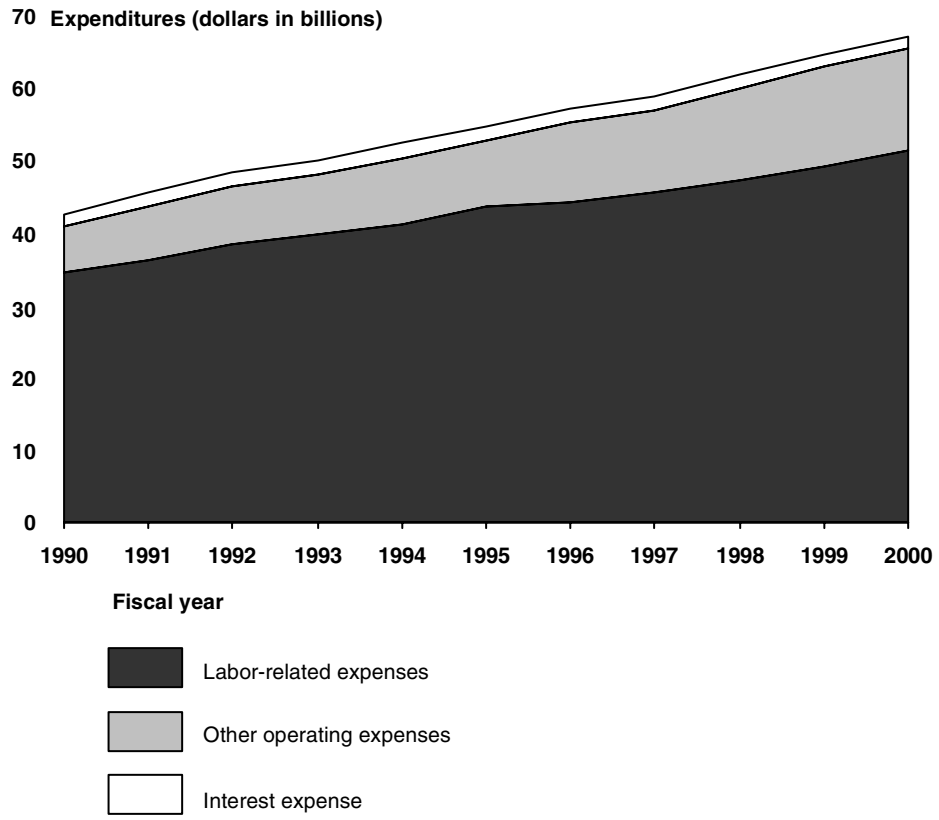
Figure 1: Postal Service Net Income From Fiscal Year 1990 Through 2002



Source: U.S. Postal Service.

One reason for the declining net income has been continued growth in postal expenses (see fig. 2). The Service's delivery network continues to grow at a rate close to 2 million new household and business deliveries each year. Labor-related expenses continue to account for more than three-quarters of the Service's total operating expenses, despite multibillion-dollar expenditures for automation. Other operating expenses have also grown.

Figure 2: Trends in Postal Service Expenses From Fiscal Year 1990 Through 2000



Source: U.S. Postal Service.

The Service Faces Growing Challenges

The Service faces growing challenges in an increasingly competitive environment as it seeks to fulfill its mission: bind the nation together through the correspondence of the people; provide access in all communities; offer prompt, reliable, and efficient postal services at uniform prices; and be self-supporting and break even financially over time. In October 1999, we testified that the Service might be nearing the end of an era and confronting increasing challenges from competition, notably from private delivery companies and electronic communication alternatives such as the Internet.[1] The Service told us that it expected First-Class Mail volume to decline substantially in the next decade, assuming that the diversion of mail to electronic communications alternatives would accelerate in a new and vastly different environment in which the Service would be required to operate.

[1] *U.S. Postal Service: Challenges to Sustaining Performance Improvements Remain Formidable on the Brink of the 21st Century* (GAO/T-GGD-00-2, Oct. 21, 1999).

In September 2000, we testified that the Service continued to face an uncertain future in an increasingly competitive environment.[2] We reported that the Service believed that growth in its core business had already been negatively affected by the rapid growth of the Internet, electronic communications, and electronic commerce. We noted that a key oversight issue for the Service, Congress, and the American people is whether the Service is heading for financial shortfalls that could, in the long run, hinder its ability to carry out its mission of providing affordable, universal services that bind the nation together. We also reported that the Service had experienced increasing difficulties in meeting its goal of $100 million in net income for fiscal year 2000. Based on its annual financial statements, the Service experienced a net loss of $199 million for fiscal year 2000, its first deficit since fiscal year 1994.

In January 2001, we reported to Congress on the potential consequences if the Service incurred a series of large deficits. These could include increases in postal rates, declines in service quality, consolidation or closure of some facilities, or reconsideration of postal operations or even the scope of postal services.[3] We also noted that fundamental issues concerning the Postal Service's role and authority have been raised in Congress, and various stakeholders have called for changing its legal and regulatory framework. We concluded that to be successful, the Service would need to address formidable performance and accountability challenges in five key areas, which can be posed as the following questions:

1. Can the Postal Service remain self-supporting while providing affordable, high-quality universal service?
2. Can the Service become more efficient by controlling its costs and improving productivity?
3. How will the Service address critical human capital issues, such as maintaining continuity and service in the face of the impending retirement of many postal employees, rapidly rising retirement and other personnel-related costs, and persistent labor-management problems?
4. Does the Service have reliable performance and cost information to effectively manage postal operations, identify inefficiencies, and track progress toward realizing anticipated cost savings?
5. What changes may be needed in the current legal and regulatory framework governing the Postal Service's role and mission so that it can remain self-supporting and provide affordable universal service in an increasingly competitive environment?

In the balance of my testimony today, I will focus on the first three questions. First, I will discuss the Service's short-term financial outlook and assess the Service's increasingly dire financial projections for this fiscal year. Second, I will discuss the Service's financial trends and issues relating to its cash and debt position. Third, I will focus on selected key long-term challenges, including human capital challenges, and conclude with some specific suggestions for action.

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[2] *U.S. Postal Service: Sustained Attention to Challenges Remains Critical* (GAO/T-GGD-00-206, Sept. 19, 2000).

[3] *Major Management Challenges and Program Risks: U.S. Postal Service* (GAO-01-262, Jan. 2001).

The Service's Short-term Financial Outlook Has Deteriorated

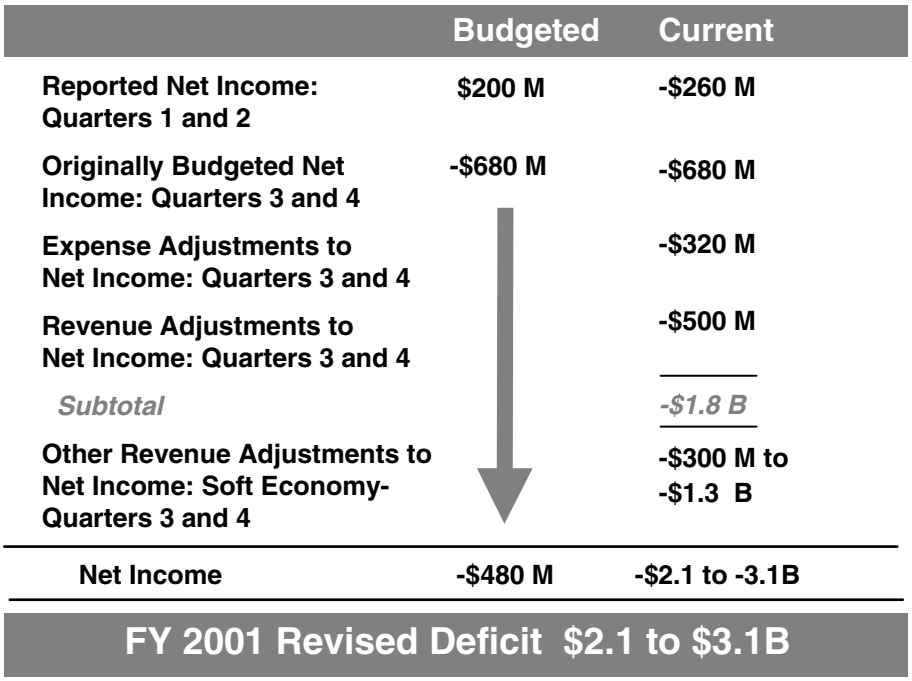
The Service is projecting significant losses over the next 2 years, although the full extent of the losses is uncertain. The Service currently estimates that its fiscal year 2001 deficit will range from roughly $2 billion to $3 billion—a sum that far exceeds the $480 million deficit built into the Service's budget that was approved last November. About $1.8 billion of this projected deficit is based on reported losses in the first 2 quarters and revised estimates for losses in the last 2 quarters. Depending on the economic situation for the rest of fiscal year 2001, the Service believes that losses could be much higher. Further, in fiscal year 2002, the Service estimates that its deficit will be in the $2.5 billion to $3.5 billion range, assuming no further increases to postal rates.

An important caveat: Our current assessment of the Service's financial outlook for this fiscal year is based on a preliminary review of the financial data and projections that the Service recently provided to us and on interviews with Service officials, including the Chief Financial Officer. The Service's financial situation is complex, and we are still assessing the validity of key data and assumptions that support the Service's financial projections. In addition, the Service is in the process of updating some of its key projections, such as projections of its revenues for the second half of this fiscal year. We will continue to review the Service's financial condition and will report again to Congress on this matter.

Factors Leading to the Service's Expected Deficit in Fiscal Year 2001

To understand the factors affecting the Service's financial outlook for this fiscal year, I will discuss where the Service stands today with results from the first 2 quarters and what it expects to happen during the last 2 quarters of the year. I will also discuss how the Service's net income projections have changed since the beginning of the fiscal year according to a series of adjustments the Service has made to its projected revenue and expenses. (See fig. 3.) Finally, I will discuss other factors that have not been included in the Service's projections but could affect the Service's financial results for this year, such as the Service's ability to achieve budgeted savings and revenues from new initiatives.

Figure 3: Changes in the Postal Service's Financial Outlook for Fiscal Year 2001



Legend: Dollars in millions (M), billions (B).
Source: GAO presentation based on U.S. Postal Service estimates, which are subject to change.

The Service's financial outlook for fiscal year 2001 can be divided into the following categories: (1) $260 million in reported losses for the first half of the fiscal year, (2) $680 million in budgeted losses for the balance of the fiscal year, (3) $320 million in expenses higher than estimated for the last 2 quarters, (4) $500 million in revenues lower than budgeted for the last 2 quarters due to lower-than-requested increases in postal rates, and (5) $300 million to $1.3 billion in revenues lower than budgeted for the last 2 quarters due to the slowing economy and its impact on mail volume and revenues. The uncertainty of the impact of the economy for the remainder of the fiscal year is the largest single factor in the Service's projections that may impact its expected losses for fiscal year 2001, and the estimated range is based on the Service's judgment.

Reported Losses for the First Half of Fiscal Year 2001

As figure 3 shows, the Service reported that its loss for the first 2 quarters of this fiscal year was about $260 million. This reported amount is not audited and is subject to change. It is important to note that 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 $260 million loss during its typically strongest earnings period is a further sign of the Service's financial difficulties. The Service had budgeted for $200 million in net income for the first half of the fiscal year; so, thus far it is running $460 million behind its budget targets. Further, the Service achieved nearly $1 billion in net income in the first half of last fiscal year – a year in which it ended with a $199 million loss.

Additional Losses Built into the Service's Fiscal Year 2001 Budget

In its fiscal year 2001 budget, the Service estimated that it would incur a $680 million deficit for the last 2 quarters of the fiscal year. When this amount is added to the $260 million deficit incurred in the first half of the fiscal year, the Service would lose nearly $1 billion in fiscal year 2001. This estimated loss does not include a number of developments that could have a negative impact on the Service's net income this year, which are detailed below.

Additional Unbudgeted Expenses

The Service currently projects that its expenses for the remaining 2 quarters of this fiscal year will be $320 million greater than budgeted, and gave us supporting information for these estimated expenses. For example, the Service told us that it is experiencing greater transportation expenses because of increases in fuel costs and cost passthroughs from its transportation contractors, among other factors. International mail expenses are also expected to be higher than budgeted because of recent increases in "terminal dues" paid to foreign postal administrations to deliver outbound U.S. international mail. Workers' compensation expenses are also expected to be greater than budgeted and to reach $1.1 billion for the full fiscal year – a significant increase from last year and the late 1990s.

Additional Revenue Shortfalls Relating to Postal Rates and New Revenue Initiatives

The Service projected revenues for the last 2 quarters of fiscal year 2001 to be $500 million below its budgeted targets due to the gap between the requested rates and those implemented in January. The Service's budget for fiscal year 2001 assumed that the Service would receive the full increase in postal rates that it had requested in the 2000 rate case. However, the Postal Rate Commission recommended a rate increase that averaged 4.6 percent—more than 2 percent lower than the requested amount. These rates were put into effect this January and included a 1-cent increase in the price of a First-Class stamp to 34 cents.

Additional Revenue Shortfalls Attributed to the Slowing Economy

The Service further lowered its revenue projections for the second half of fiscal year 2001 by $300 million to $1.3 billion on the basis of the Service's judgment of a "continued soft economy" and the resulting negative impact on mail volume and revenues. The $1 billion range reflects the Service's uncertainty associated with the length and severity of the economic slowdown and its impact on postal revenues. The Service told us it is in the process of updating its mail volume and revenue forecasts for the rest of fiscal year 2001.

Other Factors May Add to the Service's Deficit for Fiscal Year 2001

The Service's expenses could be higher than it currently estimates because it is not on track to achieve some cost-reduction targets. For example:

- The Service planned to decrease its work hours by 1.5 percent from last year's level—which would translate into a reduction of 13,200 work years for the full fiscal year. Although the

Service reported that work hours declined in the first 2 quarters of fiscal year 2001 compared to the first 2 quarters of last fiscal year, the decline was only about half of its target.

- The Service planned for decreasing overtime work hours by about 6 percent in the first 2 quarters from last year's level. However, the Service reported that overtime increased in the first 2 quarters and is running about 13 percent higher than the budgeted targets so far this fiscal year, although some recent progress has been made in reducing overtime.
- The Service's planned reductions in total work hours assume efficiency gains in most aspects of its operations. An estimated 60 percent of the savings is related to greater efficiencies in handling flat mail, such as catalogs and periodicals, and from machines sorting mail for carriers in the sequence it is to be delivered. However, these budgeted savings will be difficult for the Service to fully realize. First, Service officials told us that it takes three to six employees to prepare flat mail to be loaded into its new sorting machines, thus diminishing cost efficiency, although the Service noted it is working with mailers to address this issue. Second, the Service has reported that carrier costs exceeded budgeted targets by $130 million for the first 2 quarters of this fiscal year. Carrier costs were reportedly affected by greater-than-expected volumes of low-margin advertising mail; the worst winter weather in a decade; and difficulty in finding and retaining replacements for rural carriers, which resulted in higher overtime costs.
- The Service expected efficiency gains to result in reductions through attrition. The number of career employees has been declining, while at the same time there have been increases in the number of non-career workers. The Service has said that it might be necessary to offer voluntary early retirements in some cases, or possibly move into isolated reductions-in-force.

Strategies to Improve Net Income

To improve its net income situation in fiscal year 2001 and 2002, the Service will need to increase revenues and/or cut costs and improve productivity. Adding to this challenge will be maintaining the quality of service. The Service is currently making efforts in these areas. The following is a brief discussion of the Service's short-term potential for making further progress.

- Cut operating costs and improve productivity: We have repeatedly emphasized that this should be a priority area for the Service; however, progress historically has been difficult to achieve. Service officials have emphasized some key barriers, such as restrictions on closing unprofitable post offices or limited flexibility in changing workforce deployment, have contributed to the difficulty of making progress in this area. The Service's overall productivity has increased only about 11 percent in the past 3 decades despite vast changes in automation and information technology. The Service has recognized that it needs to make progress in cutting its costs and improving productivity and is currently taking steps to do so. Last week, the Deputy Postmaster General announced that the Service is committed to cutting costs by $2.5 billion by 2003. 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 has not yet specified, however, how these cuts would be achieved. The Service improved productivity in fiscal year 2000 by 2.5 percent and its budget for fiscal year 2001 calls for a 0.7 percent productivity increase. Service officials are also planning for a 2-percent increase in fiscal year 2002, and a 1-percent increase the year

after that—a set of positive productivity increases over 4 consecutive years that they noted would be unprecedented.

- Generate more revenues from new products and services: We believe that it will be difficult for the Service to generate significant revenues from new products and services in the next few years. Historically, as our 1998 report showed, the Service's new product and service initiatives underway during the mid-1990s generally were not profitable.[4] Further, the Service's 5-Year Strategic Plan for fiscal years 2001 through 2005, dated September 30, 2000, stated that no significant new revenue is forecast from new products and services during the next 5 years. The Service has not achieved its revenue targets from its new initiatives for the first half of this fiscal year. Recently, the Service has made downward revisions in its projected revenues from its new revenue initiatives for the second half of fiscal year 2001.

- Raise postal rates: 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 raise rates to maintain service and to meet its break-even mandate, at least in the short term. The Deputy Postmaster General recently said that the Service may not be able to avoid raising postal rates; but he added that at present, the Service does not know the timing, size, or details of the next rate case. Some stakeholders have expressed strong concern that the Service could request a rate increase of as much as 10 to 15 percent in the near future. However, the Service has also said that "This [option] would worsen the competitive position of the Postal Service and cause substantial disruption to key customer segments with little or no minimal direct substitutes for postal services, such as the publishing industry." In the long run, raising rates may drive postal customers to increase their use of other alternatives, thereby affecting mail volumes and revenues.

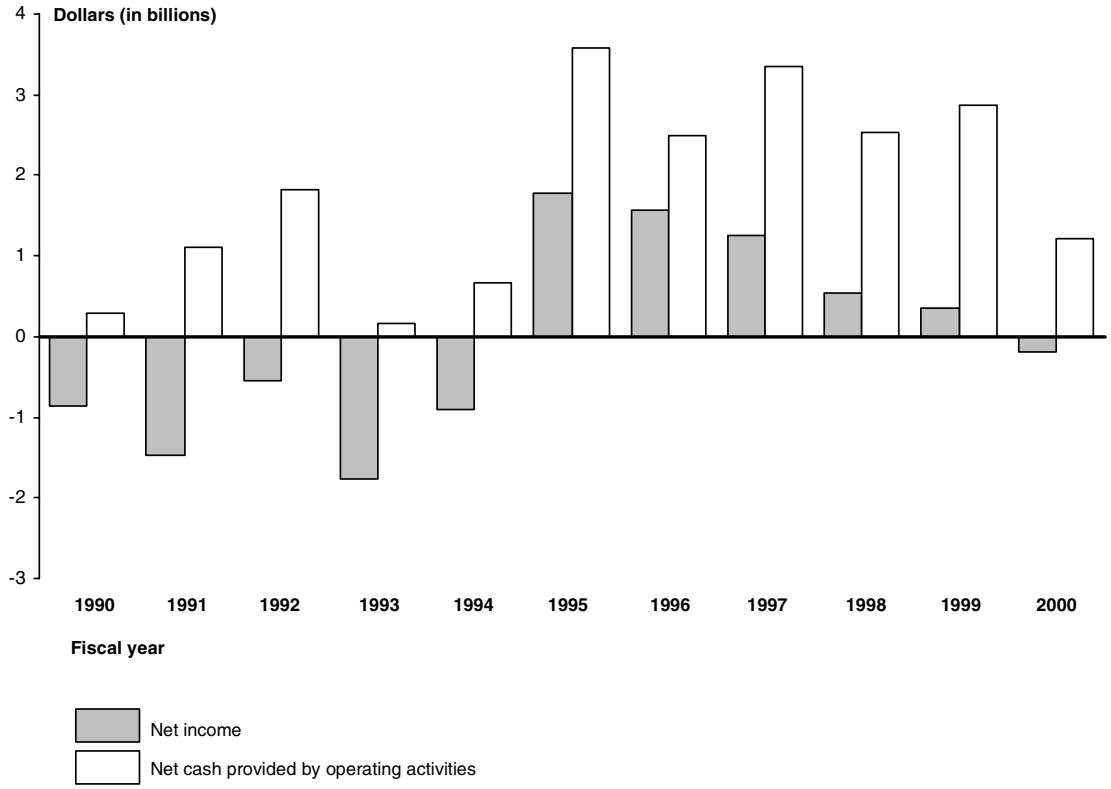
The Service Has Growing Cash Flow and Debt Challenges

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 capital investments. As shown in figure 4, the Service's cash flows from operations are typically significantly greater than its net income. The primary reason for the difference is because net income is calculated on the accrual basis of accounting[5] and includes accrued expenses, such as depreciation expense, that do not use cash.

[4] *U.S. Postal Service: Development and Inventory of New Products (GAO/GGD-99-15,Nov. 24, 1998).*

[5] 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 4: Postal Service Net Income and Cash Flows From Operations

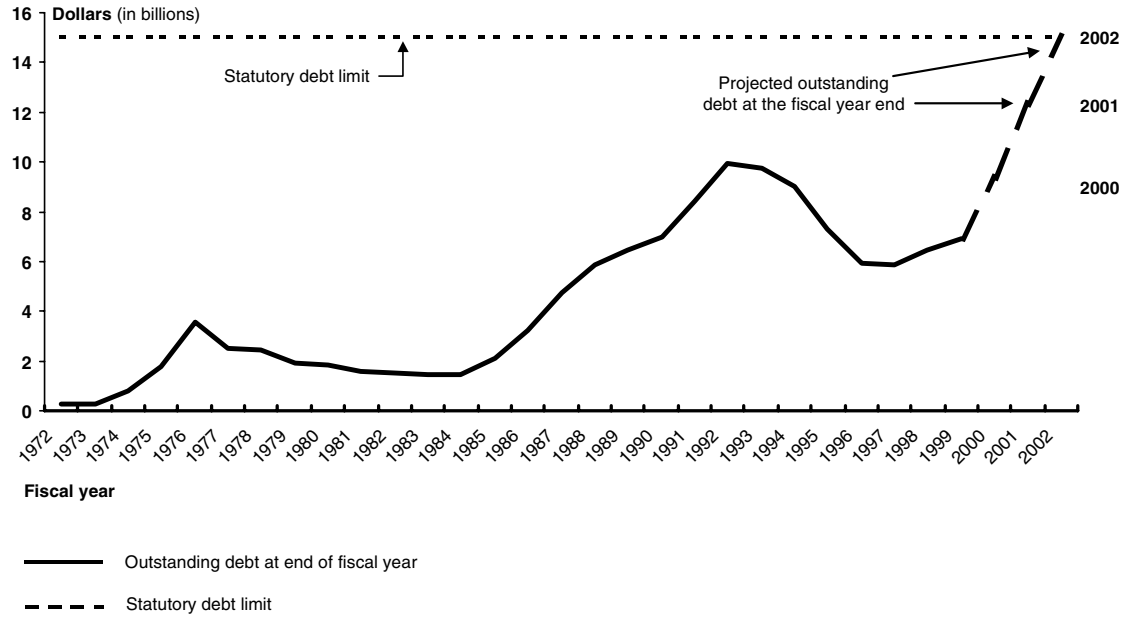


Source: U.S. Postal Service.

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 anticipates that its projected operating deficit for the full fiscal year 2001 will weaken its cash flows from operations. By way of background, the Service has a statutory borrowing limit of $15 billion and also 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).

Service officials told us that assuming the Service's financial outlook is on target and there are no further changes in postal rates in fiscal years 2001 or 2002, the Service may reach its $15 billion statutory borrowing limit by September 30, 2002 (see fig. 5). Under this scenario, the Service would have no additional borrowing authority at the beginning of fiscal year 2003. Once the Service reaches its statutory borrowing limit, it can pay its bills only through its cash on hand plus additional cash generated from operations until outstanding debt declines. The Service typically generates a cash surplus in the first part of the fiscal year. However, depending on the Service's income and cash from operations, the Service may face a cash shortage in fiscal years 2002 and/or 2003.

Figure 5: Trends in Postal Service Debt



Source: U.S. Postal Service

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. 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 $2 billion in capital commitments this fiscal year. Preliminary budget plans for fiscal year 2002 would reduce capital investment from $3.7 billion to $2.4 billion. However, reducing needed capital investments serves only to defer capital improvements and associated efficiency gains.

Major Long-Term Performance Challenges Facing the Service

As difficult as the Service's short-term financial outlook may be, we are also concerned about its long-term prospects, given the trends toward increasing competition and its implications for postal revenues, coupled with continued upward pressure on postal costs, and human capital challenges. Therefore, unless the Service makes much more rapid progress in cutting costs and improving productivity, it will face increasing difficulty maintaining its position as a self-supporting provider of universal postal service at reasonable rates. The Postal Service and postal stakeholders have been debating for years whether major changes are needed in the legal and regulatory framework governing the Postal Service, but reaching consensus among the diverse stakeholders has been difficult to achieve.

To address the Service's long-term outlook, a fundamental reassessment of the Service's financial options and operating plans is in order. Better information may also be needed about recent changes in the dynamic postal and delivery sector, as well as on the short and long-term effects of postal rate changes on mail volumes, revenues, and costs. Further, an assessment is needed of the full range of actions that the Service can take under current law and identifying

areas where actions are needed. In making such a reassessment, which should also include identifying areas where statutory changes may be needed, the Service should consult with its stakeholders including unions and management associations, customers, and the Postal Rate Commission.

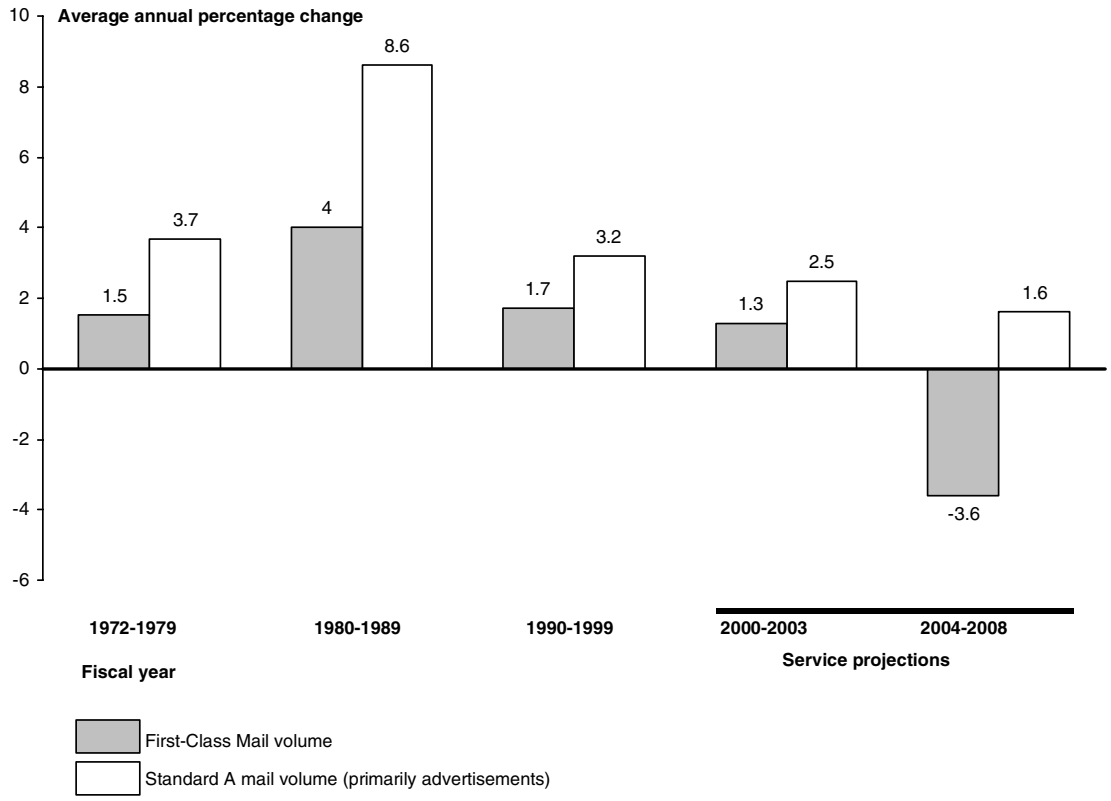
The Service's Viability to Fulfill Its Historic Mission

The Service faces greater competition and expects electronic diversion to cause substantial declines in First-Class Mail volume in the next decade which, according to the Service's most recent 5-year Strategic Plan, would place the Service under "extreme financial pressure." In this event, the Service, like many of its foreign counterparts, would likely face unprecedented challenges to its primary mission of providing universal postal service at reasonable rates while remaining self-supporting from postal revenues. The growing challenges are as follows:

- The Service would face the challenge of responding to any volume declines or changes in the mail mix by attempting to reduce mail processing, personnel, and other costs that have traditionally been considered to vary with changes in mail volume. Labor-related expenses continue to account for more than three-quarters of total postal service operating expenses and have reportedly been difficult to cut quickly in response to less-than-expected mail volumes and revenues. This fiscal year, the Service reported it has experienced continuing difficulty cutting costs when expected mail volumes and revenues did not materialize.
- If First-Class Mail volume declines and the revenue loss is not offset in other areas, rates would need to rise for any mail categories that take on a larger burden of supporting postal institutional costs. The Service maintains a delivery and retail network that includes more than 235,000 city and rural delivery routes; more than 38,000 post offices, stations, and branches; and more than 350 major mail processing and distribution facilities.
- Even if First-Class Mail volumes do not decline, Service officials expect that cost reductions may not be sufficient to keep future rate increases below the rate of inflation.
- Adding to rate pressure, postal infrastructure costs continue to grow. The Service has been adding many new delivery points to new households and businesses—a projected 1.8 million in fiscal year 2001.

Competition is already increasing from private delivery companies, foreign postal administrations accepting outbound international mail from within the United States; and electronic communications alternatives, such as the Internet. As an example of trends that have already affected the Service's mail volumes, federal agencies are mandated to move as quickly as possible to reduce paperwork and to adopt electronic billing and payment. Two-thirds of the 880 million Social Security checks, tax refunds, and other payments that were sent by the Department of the Treasury in fiscal year 1999 were sent electronically. Further, the banking industry's mail volume was almost 18 percent lower in 1999 than it was in 1996. According to the Service, longer term projections suggest that about half of the bills and payments that are currently mailed will eventually be replaced with electronic billing and payment alternatives. It is difficult to predict the timing and magnitude of further mail volume diversion to electronic alternatives and the potential financial consequence. Based on anticipated electronic diversion, the Service's baseline forecast in its 5-Year Strategic Plan calls for total First-Class Mail volume to decline at an average annual rate of 3.6 percent from fiscal years 2004 through 2008 (see fig. 6).

Figure 6: Postal Service Projects Decline in First-Class Mail Volume



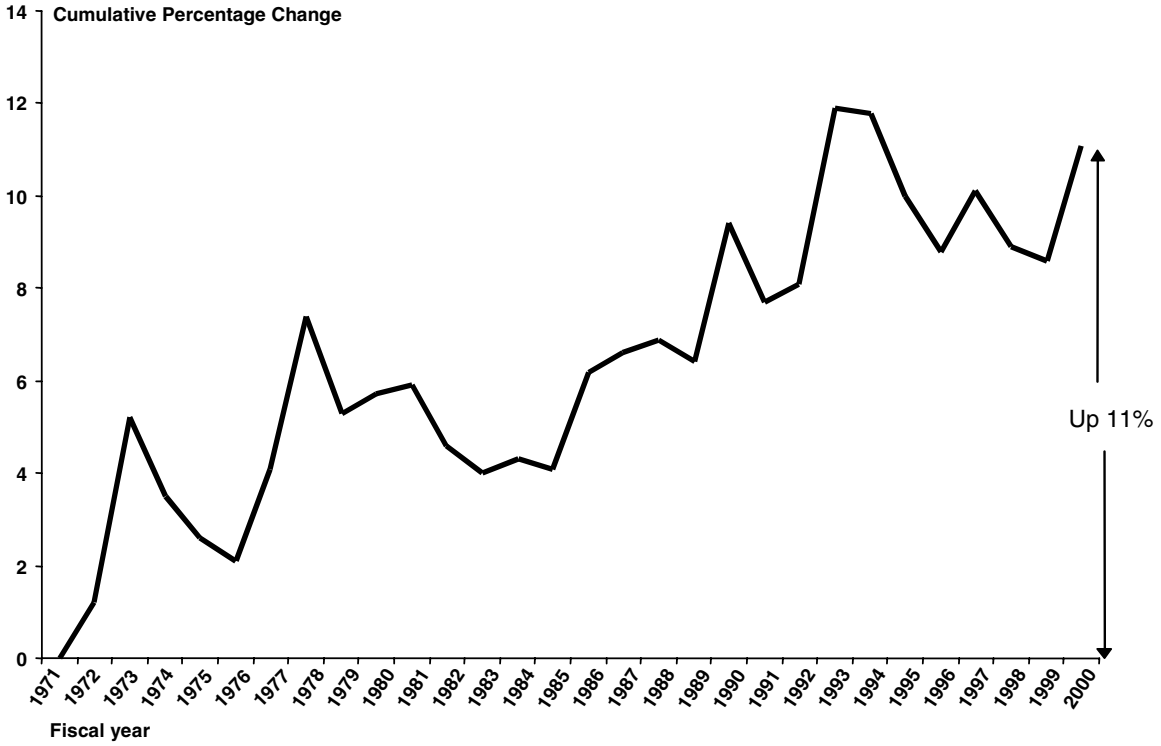
Source: U. S. Postal Service.

The Postal Service has raised the possibility that its financial problems may lead to cutting back universal postal service. A postal official recently said that the Service might ultimately reduce mail delivery from 6 to 5 days each week to remain financially sound. Can the Postal Service continue to maintain the scope and quality of its retail and delivery services? The answer, at least in the short term, is "yes" – but in the long term, the Service's prospects are uncertain.

Control Costs and Improve Productivity

We have previously reported that the Service's continued success will depend heavily on its ability to control operating costs and improve productivity. 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. 7). As the Postal Service and key stakeholders have recognized, 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 OIG, have noted inefficiencies in the postal system and difficulties the Service has had in realizing opportunities for savings. The OIG has recently identified potential cost savings and is working to identify further opportunities.

Figure 7: Postal Service Productivity Growth Since Fiscal Year 1971

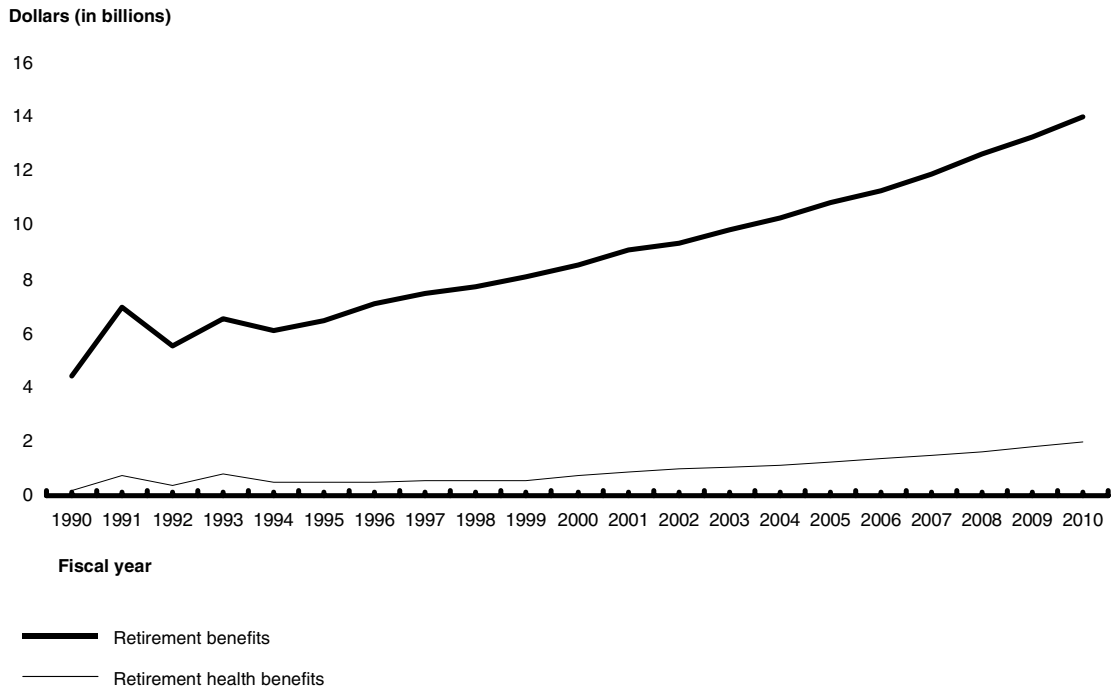


Source: U. S. Postal Service.

The Service's ability to improve productivity and control costs is constrained by a number of factors, such as its requirement to provide postal services to all communities and the requirement that postal wages be determined by binding arbitration when the Service and its labor unions cannot reach agreement. The Service has also reported that extensive work rules and other regulations hamper its flexibility and innovation. In addition, the Service has a self-imposed moratorium on closing post offices and by statute, it cannot close small post offices solely for operating at a deficit. Further, fiscal year 2001 appropriation legislation specifies that the Service cannot close small or rural post offices in fiscal year 2001. The Service estimated several years ago that about half of all post offices do not generate sufficient revenues to cover their costs.

In addition, some employee-related expenses are rising and are difficult to control, such as retirement-related expenses. The Postal Service's retirement-related expenses—that is, the payments the Service makes each fiscal year—have increased in recent years, and these trends are expected to continue (see fig. 8). According to the Service, its retirement expenses 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 recognizes that it needs aggressive cost management, and the Postmaster General has called for achieving "breakthrough" productivity savings of $1 billion annually, mainly in mail processing, transportation, and administrative areas. However, the Service's fiscal year 2001 budget called for saving only $550 million through such productivity initiatives. The Service is making ongoing efforts to standardize and improve work processes to reduce significant variations in quality, productivity, and costs across the system. The Service is also planning to implement activity-based costing in certain processing facilities to enable it to track activity costs and rates that can be compared across facilities for benchmarking, performance measurement, and budgeting purposes. Another example of potential cost savings that the Service is working to address includes manual processing of mail, which reportedly accounts for half of all labor mail processing costs.

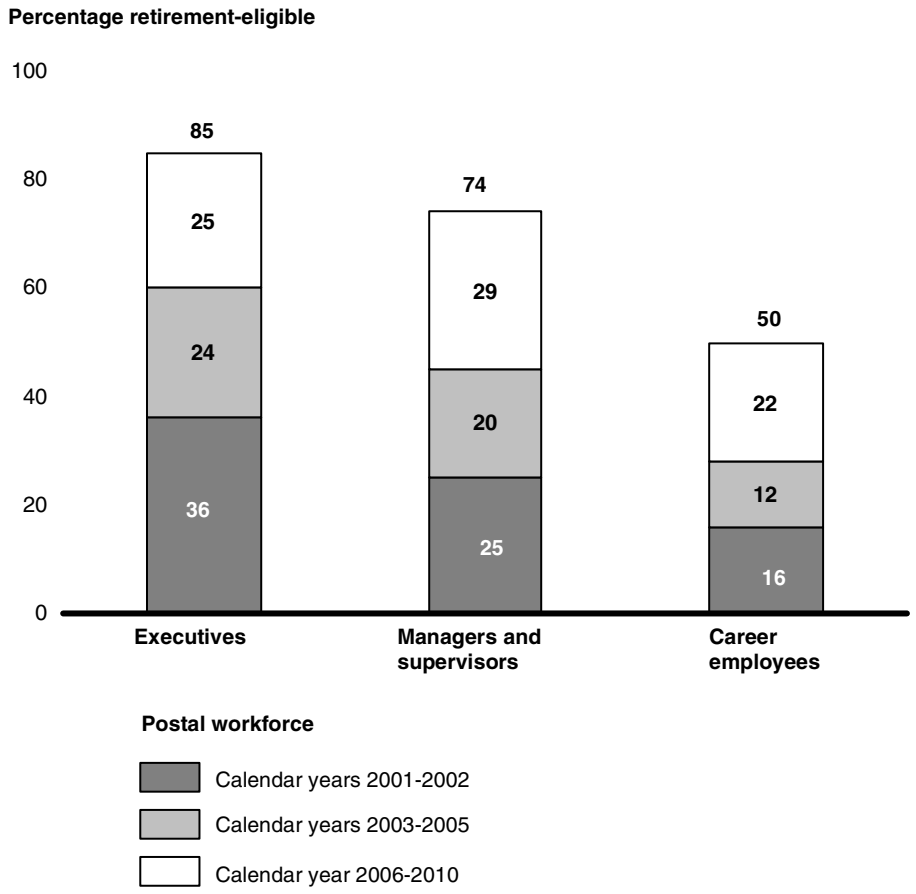
Human Capital Challenges

The Service's Strategic Plan stated that the expected decline in postal workload—in part due to automation and the implementation of information technology—"will inevitably result in both restructuring and a reduction in the workforce." Some of the planned reductions are to be accomplished through eliminating staff vacancies and the work associated with them. We believe that these reductions should be done in a carefully planned manner to avoid negatively impacting the workplace environment, operations, and service quality. In addition, with a large percentage of the postal workforce nearing retirement eligibility, the Postal Service has the opportunity to reduce the size of its workforce; but the Service will be increasingly challenged to deal with human capital issues related to succession planning, maintaining continuity, and the associated

cost issues. The Service will need to maintain the continuity of service to customers as many experienced managers and workers retire and the Service restructures its workforce.

The Service has projected that among its current employees as of October 2000, in calendar years 2001 and 2002 about 130,000 postal employees are already eligible, or are projected to reach eligibility, for regular retirement. 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).

Figure 9: A Large Percentage of the Postal Workforce Is Nearing Retirement



Source: U. S. Postal Service.

The Postal Service faces additional difficult human capital challenges that must be successfully addressed to maintain organizational effectiveness and improve the workplace environment as well as control workforce costs. These challenges include (1) restructuring the postal workforce of about 900,000 career and non-career employees and reducing the number of employees, and (2) ameliorating persistent problems in the workplace that have been exacerbated by decades of adversarial labor-management relations. The Postal Service's human capital problems can be seen as part of a broader pattern of human capital shortcomings that have eroded mission

capabilities across the federal government. The Service and its major unions and management associations need to resolve long-standing labor-management problems that have hindered improvement efforts, including efforts to cut costs and increase productivity. In addition, the Service has recognized the need to provide its employees with the tools and incentives necessary to allow effective participation in planning and implementing improvements.

Actions Needed

We are placing the Service's transformational efforts and long-term outlook on our High-Risk List, effective immediately. The Service is at growing risk of not being able to continue providing universal postal service vital to the national economy, while maintaining reasonable rates and remaining self-supporting through postal revenues. A structural transformation of the Service is called for. The Service's financial outlook has deteriorated significantly since last November and it now projects $2 billion to $3 billion in expected losses in fiscal year 2001 and an even higher deficit in the next fiscal year if there is no additional rate increase. The Service has been increasing its borrowing and is approaching its $15 billion debt ceiling without any debt reduction plan. The Service recently deferred capital investment to conserve cash, thus delaying needed improvements and associated gains in efficiency.

In addition, 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." Further, the Service anticipates substantial losses in First-Class Mail volume over the next decade that would create "extreme financial pressure." If the Service experiences a series of large financial deficits, universal postal service could ultimately be threatened, prices would likely increase at a much faster rate, and other options would need to be explored.

While 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. Inclusion of the Postal Service's transformational efforts and long-term outlook 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.

The significant shift in the Postal Service's financial outlook in the last 4 months came as a surprise to a variety of key stakeholders. In order to understand the Service's financial and human capital problems, Congress and postal stakeholders need to have frequent, transparent, and reliable information on the Service's current and projected financial situation, the Service's plans to address its growing challenges, and what progress the Service is making. Therefore, we believe the following actions need to be taken:

- The Service should develop a comprehensive plan, in conjunction with Congress and other stakeholders, such as the postal unions and management associations, customers, and the Postal Rate Commission, that would identify the actions needed to address the Service's financial, operational, and human capital challenges and establish a timeframe and specify key milestones for achieving positive results.

- The Service should 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 towards achieving the desired results specified in its comprehensive plan.

- GAO will work with Congress and the Service to help identify improvement options and will continue to analyze and report to Congress on the Service's ongoing financial condition. In consultation with other postal stakeholders including the Postal Service Office of Inspector General, postal unions and management associations, the Postal Rate Commission, and customers, we will review the Service's financial results and future outlook, progress on cost-cutting and productivity efforts, other countries' experiences, and options for addressing the Service's short-term and long-term challenges.

Mr. Chairman, that 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

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