Ensuring a Viable Postal Service for America

An Action Plan for the Future

UNITED STATES POSTAL SERVICE

EXECUTIVE SUMMARY

For over 200 years, the Postal Service has fulfilled its mission to deliver trusted, affordable service to the nation. Its business model worked well because mail volume increased steadily as the nation grew. In recent years, however, as customer preferences have rapidly evolved and new technology has changed how Americans communicate and transact business, the model has faltered. Mail volume, instead of increasing, is declining dramatically, even as the cost of delivering mail to an expanding number of addresses continues to grow. As a result, the Postal Service's ongoing ability to finance universal service is at great risk.

In the face of these challenges, the Postal Service has responded aggressively, saving over $1 billion every year since 2001, including $6.1 billion savings in 2009 alone. Yet these savings are not sufficient to counter underlying shifts in the business of mail. A loss of more than $7 billion is projected for 2010, and with current trends expected to worsen over the decade, the Postal Service will be pushed more deeply into crisis. Without fundamental change, cumulative losses could reach more than $238 billion by 2020.

To avoid potential insolvency, the Postal Service has developed an ambitious but achievable plan, taking steps allowed under current law to reduce the projected gap by $123 billion. These savings would be unprecedented, even by the standards set over the last several years. And even if its plan was to succeed in every action that present legislation allows, the Postal Service would still face unsustainable losses of at least $115 billion by 2020. This remaining gap can be closed, and the Postal Service can continue to fulfill its mission at no cost to American taxpayers, but only with additional flexibility that would have to come through legislative changes. They include:

1. **Retiree Health Benefits Prefunding.** Restructure retiree health benefits payments to "pay-as-you-go," comparable to what is used by the rest of government and the private sector. This equates to an average of $5.6 billion in cash flow per year through 2016. Address overpayments to the Postal Service's Civil Service Retirement System pension fund.

2. **Delivery Frequency.** Adjust delivery days to better reflect current mail volumes and customer usage. Survey data show that the public favors 5-day delivery over using taxpayer funds and other alternatives.

3. **Expand Access.** Modernize customer access by providing services where the customers are. Increase and enhance customer access through partnerships, kiosks, and improved online offerings, while reducing costs.

4. **Workforce.** Establish a more flexible workforce that is better-positioned to respond to changing demand patterns as over 300,000 employees become eligible to retire in the coming decade.

5. **Pricing.** Ensure that prices of Market Dominant products can be based on the demand for each individual product and its costs, rather than capping prices for every class at the rate of inflation. In addition, pursue a moderate exigent price increase effective in 2011.

6. **Expand Products and Services.** Permit the Postal Service to evaluate and introduce more new products consistent with its mission, allowing it to better respond to changing customer needs.

7. **Oversight.** Reinforce these changes with more clearly defined, appropriate, agile oversight roles and more streamlined processes.

Without question, the current situation is a crisis for the Postal Service, the mailing industry, and indeed for all postal stakeholders. It is also an historic opportunity — providing a chance to make positive and very practical changes that not only meet the present crisis, but also lay the foundation for a leaner, more market-responsive Postal Service that can thrive well into the future.

Contents

Understanding the Universal Service Obligation

The Universal Service Obligation ensures that every citizen can send and receive mail at affordable prices. This entails maintaining a delivery network that reaches all addressees, and providing customers with ready access to postal services, a range of products, uniform prices and mail security.

INTRODUCTION

Since Benjamin Franklin was appointed the first Postmaster General, the agency known today as the United States Postal Service has fulfilled its mission to deliver trusted, affordable service to the American people. From the Pony Express to today's fast-changing digital world, the Postal Service has dramatically improved service and efficiency, ensuring that consumers and businesses get world-class mail services at reasonable prices.

The Postal Service is the world's most efficient post. A First-Class stamp costs just 44 cents, while other major posts charge an average of 78 cents. Customer satisfaction and service levels have reached the highest levels ever reported. For five years in a row, the Postal Service has also been voted the "Most Trusted Government Agency" for protecting customer privacy, and rates in the Top 10 of all public and private entities.

The Postal Service's business model dates to 1970, when it became an independent agency of the Executive Branch. In contrast to the heavily subsidized department it replaced, the Postal Service was designed to operate like a business, financing its operations from the sale of its products and services.

This self-financing model worked well for many years as mail volume grew with the nation. In recent years, however, volume has declined, and it continues to fall as technology rapidly reshapes the market and changes how Americans communicate and conduct business. The recent economic downturn accelerated this trend as businesses cut expenses and reduced their investment in mail.

For most businesses, there is nothing exceptional in this; they must continually adapt to technology and market changes. Unlike most businesses, however, the Postal Service is attempting to meet its 21st century challenges with a business model suited to the last century — one that does not acknowledge that a fundamental change has taken place.

Mail is big business. The Postal Service is at the core of the trillion dollar mailing industry that employs more than 8 million people.

Prudent management required that the Postal Service make substantial adjustments to compensate for the decline in volume and revenue. To the extent that current law allows, it has done just that, saving over $1 billion every year since 2001, including $6.1 billion in 2009 alone. Unfortunately, its ability to make adjustments is limited in the areas where costs are highest — wages and benefits, its network, and the interpretation of the Universal Service Obligation.

In 2006, Congress passed new legislation that significantly modified the postal business model. It provided limited pricing freedom in Competitive Products but offered little flexibility for the remainder of the business. The law also limited the Postal Service's ability to create new products and seek new sources of revenue. It capped prices at the Consumer Price Index by class for Market Dominant products, which is 88 percent of revenue. And without providing additional flexibility to control its costs, the law added a massive new obligation: to pre-pay future retiree heath benefits on a schedule that consumes 10 percent of revenue every year. These changes in the law were made just as volume had begun to fall and the recession began to take hold.

The Postal Service responded with comprehensive actions to transform operations. It increased the use of automation and substantially reduced its workforce, all while improving service. Despite these improvements, the Postal

Service began to suffer significant net losses in 2007 primarily due to a legislatively imposed requirement to prefund future retiree health benefits.

This paper explains the current crisis and presents an action plan to meet it. The plan has two parts: the first includes aggressive actions that the Postal Service commits to making within existing law; the second describes additional actions, most requiring changes in law, that are vital to restore financial stability.

This plan is the product of more than a year of dialogue between the Postal Service and members of Congress, the Administration, the business community, postal employees, and the general public. To gain a fresh, objective perspective, the Postal Service solicited papers from a number of independent sources, and enlisted three of the world's most experienced and highly regarded management consulting organizations — Accenture, The Boston Consulting Group, and McKinsey & Company. All three were given free rein to talk with employees, customers, and anyone else whose opinions they considered relevant.[1]

I. AN UNSUSTAINABLE BUSINESS MODEL

Since 2006, the Postal Service has faced the financial strain of steep declines in volume and revenue, combined with increases in network costs, wages and benefits, and new legal requirements. It began to incur large net losses in 2007 (Exhibit 1).

Volume and revenue have fallen sharply

From 2006 to 2009, volume declined 17 percent, from 213 billion to 177 billion pieces, while prices remained capped at the rate of inflation — triggering a loss of

In 2003, the President's Commission on the U.S. Postal Service said, "Now is the time to…modernize the Postal Service to not only preserve its future, but also to ensure its service to all Americans." This action plan is fairly consistent with the President's Commission's findings.

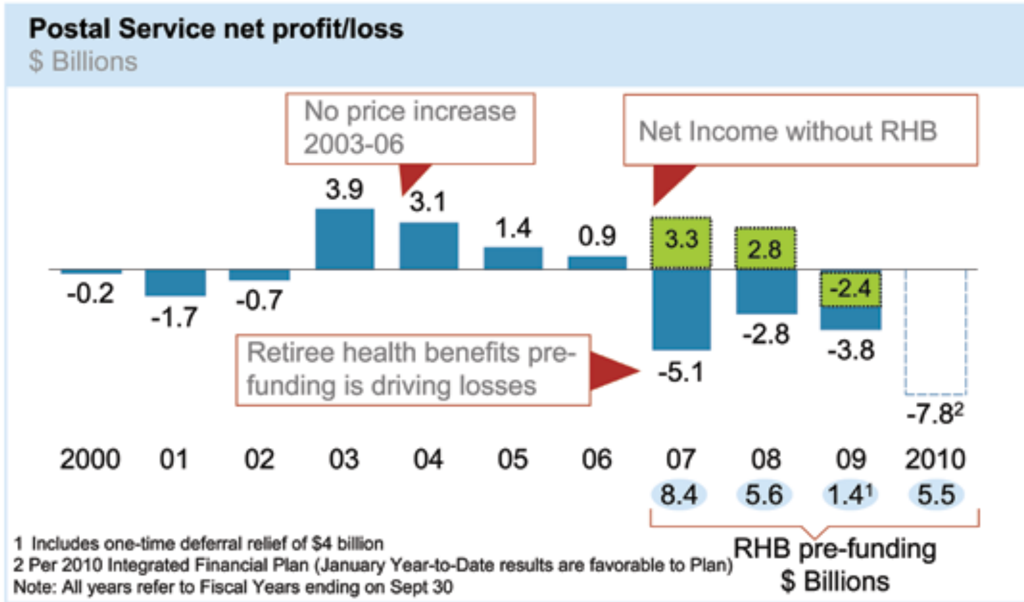
Postal Service operations are not funded by taxpayers

Throughout most of the nation's history, its postal system was administered by the Post Office Department, a cabinet level agency. By the late 1960s, however, years of financial neglect and fragmented control had impaired the ability of the department to respond to changing conditions and increasing mail volumes.

Convinced that fundamental change was necessary, in 1970 Congress enacted the Postal Reorganization Act. This sweeping legislation created the Postal Service as an independent establishment of the Executive Branch and directed the new organization to bring modern business methods and practices to the national mail system. For 36 years, the Postal Service's business model worked very well for customers, employees, and the nation. The Postal Service was able to charge affordable prices and use revenues from its products to provide mail service to all areas of the country, charging customers the same prices regardless of delivery costs. It received no taxpayer subsidies to fund its operations.

The Postal Accountability and Enhancement Act of 2006 (the Postal Act of 2006) split postal products into Competitive and Market Dominant. At the same time, the Act put the bulk of revenue-generating products under a stringent price cap and gave the Postal Service limited ability to control its costs or increase revenue. The viability of the Postal Service under the Postal Act of 2006 relied on the underlying presumption that mail volume would continue to grow. It hasn't.

Exhibit 1: USPS is experiencing unprecedented losses



SOURCE: USPS

$15.8 billion in 2009 revenues.[2] First-Class Mail saw the largest volume decline, about 15 percent. This had a disproportionate effect on the bottom line since First-Class Mail provides the majority of contribution (Exhibit 2). In total, the volume decline outpaced even the most pessimistic forecasts.

While the recession accelerated the volume decline, its primary cause is a fundamental and permanent change in mail use by households and businesses. Hardcopy communication of all types continues to shift to digital alternatives. More people are paying bills and transacting business online. Advertisers are switching from print

The volume of high-contribution First-Class Mail has declined sharply, and is expected to continue to fall.

Exhibit 2: Changes in volume and contribution of the two largest mail classes

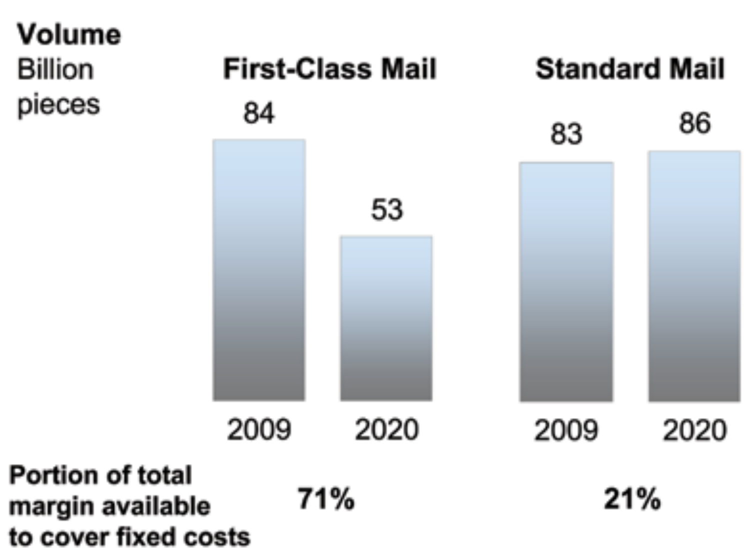
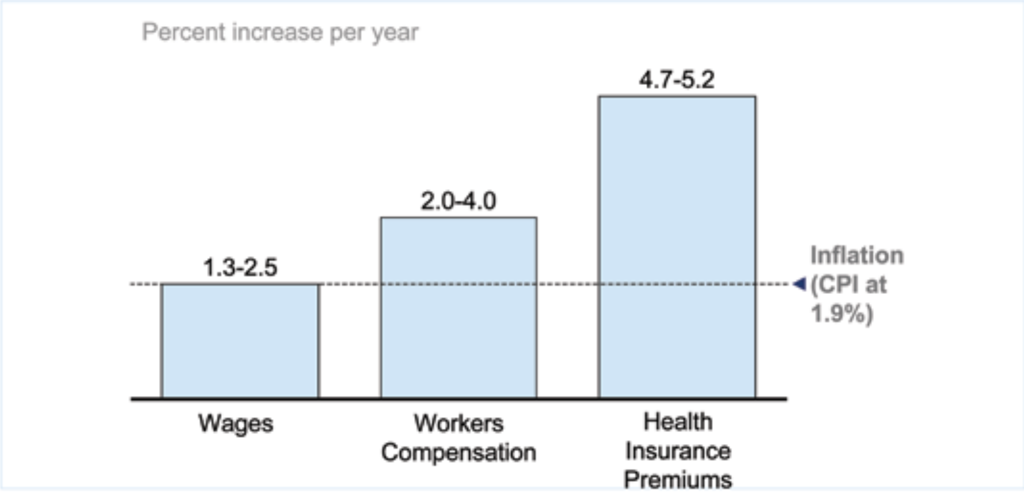


Exhibit 3: Workforce costs are projected to rise between 2010 and 2020



SOURCE: McKinsey analysis, Global Insight

Workforce costs will rise at a rate greater than prices, which are capped at inflation.

to Internet and mobile channels. And while online purchases have increased the volume of packages, this part of the Postal Service's revenue stream is not large enough to offset overall mail volume trends.

New costs and capped prices

A key driver of the cost of delivering mail is the obligation to deliver to virtually every mailing address, regardless of volume, 6 days per week. Fulfilling this duty requires an extensive network of Post Offices, processing plants, vehicles, and delivery employees. These costs are largely fixed, so they increase with the size of the network, which has grown by an average of 1.4 million new addresses every year. As a result of the growth in fixed costs and increases in other expenses, the total cost per piece of mail rose from 34 to 41 cents since 2006.

The Postal Act of 2006 was passed before volume had begun to fall sharply. It had the unintended consequence of constraining the Postal Service's ability to respond to the challenges in a financially responsible manner. The Act introduced two crucial restrictions.

First, it added a major new cost. It compelled the Postal Service to set aside money over 10 years to cover future retiree health benefits. This prefunding mandate requires that the Postal Service set aside, on average, $5.6 billion per year through 2016.[3] This has the effect of increasing total costs in this period by 9 percent a year. Prefunding is unique to the Postal Service within the public sector, and is not required in the private sector.

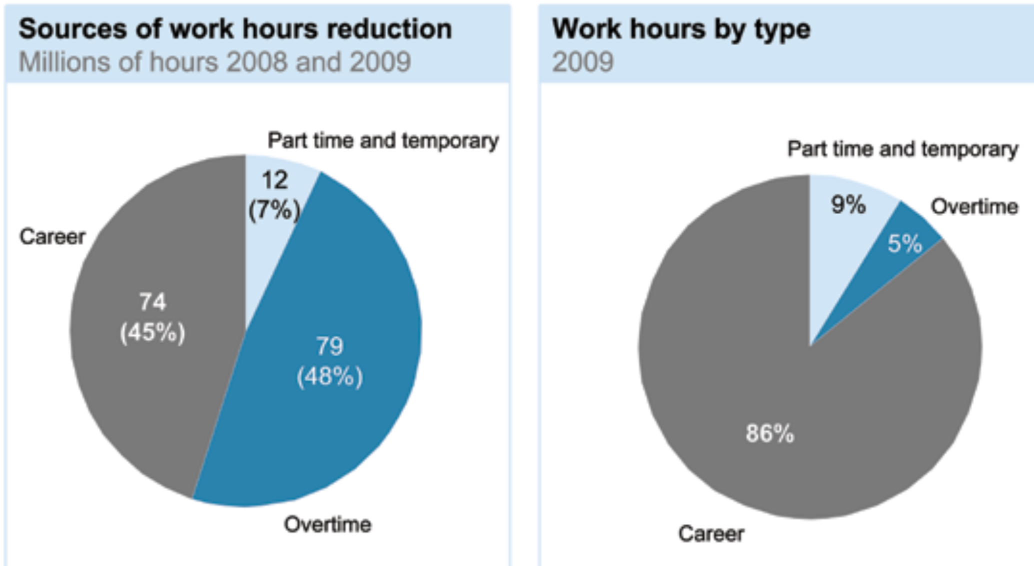
Second, the Act capped price increases at the Consumer Price Index (CPI) for each class of mail where the Postal Service is perceived to dominate a market (e.g., First-Class Mail).[4] Looking forward, the losses due to volume declines and retiree health benefits prepayments cannot be made up with increased prices (Exhibit 3).

The Postal Service aggressively cut costs while improving service

The Postal Service responded to the volume declines by dynamically reducing work hours and improving internal operations. This reduced 2009 costs by $6.1 billion. In 2009, natural attrition and early retirement offers allowed the Postal Service to reduce the workforce by the equivalent of 65,000 full-time employees, or approximately 10 percent (Exhibit 4). This was the largest one-year reduction in postal history. The Postal Service also froze hiring and executive pay.

There is limited remaining opportunity to reduce part-time, temporary, and overtime work hours.

Exhibit 4: Work hour reductions



SOURCE: FY 09 10-K; 2008 and 2009 National Payroll Hour Summary Report

Operations were streamlined consistent with this smaller workforce. The Postal Service consolidated delivery routes, reorganized portions of its processing network, and renegotiated over 500 supplier contracts to obtain more favorable terms.

To boost revenue, the Postal Service enhanced programs such as Parcel Select, which provides last-mile delivery for FedEx and UPS, among others. It launched an advertising campaign ("If it fits, it ships") for Flat Rate Priority Mail, which is priced on the size of the box, not the weight or zone, making the shipping process more convenient. The Postal Service also introduced innovative new programs such as the "Summer Sale," which boosted volumes and retained customers by offering a 30 percent discount for incremental Standard Mail (advertising mail) volume. Additionally, it invested in expanding customer access through improvements to its website and partnerships with retailers.

II. A RAPIDLY WORSENING CRISIS

Even with all these actions, the Postal Service has, in recent years, been unable to stem broader financial losses. In 2007, it began to suffer net losses, which are expected to exceed $7 billion in 2010. The Postal Service is now in the position of having to borrow from the Treasury to meet its obligations to the Treasury. Its future borrowing capacity is limited by law at $15 billion, a level it could reach in early FY 2011.

Industry experts confirm that the marketplace trends challenging the Postal Service in recent years are expected to accelerate. The organization will continue to face declining volume, stagnant revenue, large fixed costs, and rising workforce costs. Without additional action to address these trends, the Postal Service would face annual losses as great as $33 billion by 2020 (Exhibit 5).

Volumes projected to steadily contract, and revenues to stagnate

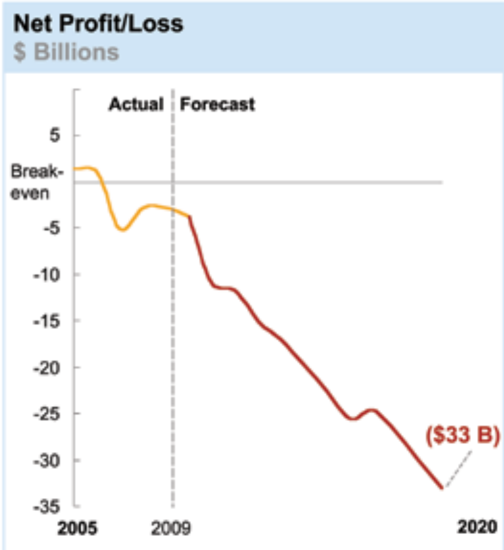
The recession is not only reducing volume due to declining business activity. It is also pushing businesses to find less expensive methods of communicating with their customers. In coming years, this will speed up the more fundamental underlying trends that are motivating customers to switch to electronic alternatives.

Total volume — which fell 17 percent from a high of 213 billion pieces in 2006, to 177 billion pieces in 2009 — is expected to drop an additional 15 percent by 2020, to a level of 150 billion pieces (Exhibit 6).[5]

In real terms, revenue will decline significantly over the next decade. In nominal terms, overall Postal Service revenues will be largely stagnant, rising from $68.1 billion in 2009, to just $69.3 billion by 2020. As a result, assuming prices by class remain capped at inflation, revenues per address will have fallen from a daily average of $1.50 in 2009 to $1.41 in 2020. [6]

First-Class Mail. Even as the economy rebounds, First-Class Mail volume will not return to past levels; it is expected to fall an additional 37 percent by 2020. Invoicing and payments will continue to move online, and businesses will continue to expand their use of electronic channels as a low-cost means to process payments and manage customer relationships.

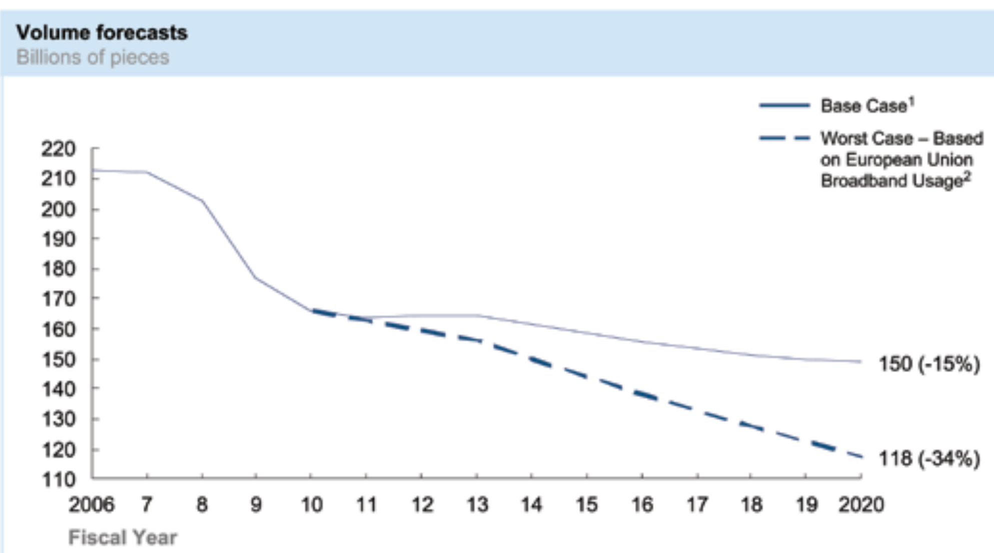
Exhibit 5: Projected net loss in 2020



SOURCE: McKinsey analysis

Without any additional action, negative forces result in increasingly large annual deficits, culminating in a $33B annual loss in 2020. Cumulative losses between now and 2020 would exceed $238B.

Exhibit 6: Volume forecasts to 2020



Benchmarking of mail trends in highly internet-enabled countries suggests that if online diversion achieves the worst-case penetration seen in the EU, the 2020 projection will fall below 120B pieces.
1 Baseline: Excludes all management actions not currently in the Postal Service budget beyond 2009. This assumes no major economic or other disruptions and no change in the postal oversight framework.
2 Worst case: Based in part on online diversion trends in highly internet-enabled European Union countries.
SOURCE: BCG analysis

The volume forecasts include high levels of uncertainty, although trends point downward.

This creates the perfect storm, eroding mail's primary role as an invoice and bill payment medium. The consumer shift online will result in a projected 1.1 billion fewer letters per year over the next decade, while businesses are expected to mail 10 billion fewer bills by 2020. Total bill and invoice mail volume is expected to fall by 44 percent, and the mix of mail is expected to shift away from First-Class Mail to less expensive Standard Mail.

Advertising mail. The volume of advertising mail has fallen rapidly in the recession along with most other advertising media. A large share of advertising investment has moved to Internet and mobile channels. One top marketing agency observed companies moving one-third of direct mail acquisition spending online. Consequently, the segment of the Postal Service's business that historically grew steadily with Gross Domestic Product (GDP) is expected to remain flat for the foreseeable future.

Packages. This segment is likely to experience some growth, but at a rate of only 3 percent per year. Letter volume declines will far outweigh package growth in both pieces and revenue.

Costs will continue rising

Today, fulfilling the Universal Service Obligation involves more than 36,000 Post Offices, stations, and branches. Delivering mail 6 days a week involves 220,000 vehicles, $2.6 billion in air transportation, and 600 processing facilities.

As volume continues to decline and the number of addresses continues to increase, the cost to deliver each piece of mail will keep rising while revenue per delivery point falls. Each year through 2020, volume is expected to decline by 1.5 percent on average while approximately 1.2 million delivery points are added.

Maintaining the Postal Service retail network will be increasingly costly. The average Post Office is far more expensive to operate than other means of serving customers. The average Post Office transaction costs 23 cents per dollar of revenue, while the average transaction at a contract postal unit costs just 13 cents (Exhibit 7). In the past, Post Offices generated almost all postal retail revenue. Today, however, 29 percent is generated through *usps.com* and other alternative channels. Post Offices recorded

Given First-Class Mail trends, retail revenues are expected to fall another 40 percent by 2020.

Exhibit 7: Channels for accessing postage & mailing packages

Outlet Type	Average Cost per Dollar of Retail Revenue	Convenience (Hours of operation)
Average Post Office[1] (Postage & Packages Only)	$0.23	9am – 5pm, Monday – Friday, limited weekend
Contract postal unit	$0.13	Avg. 7am—9pm, Monday – Sunday
Online Postage (e.g. Click-N-Ship, PC Postage, eBay)	$0.08 - $0.12	24 / 7
Kiosk (automated, self-service)	$0.12	24 / 7
Stamps by mail, phone, Internet	$0.08	24 / 7
Retail partners	$0.02 - $0.07	Avg. 7am—9pm, Monday – Sunday

1 Average cost for all retail transactions at a Post Office is $0.31-$0.39 per dollar of retail revenue.
SOURCE: USPS EDW system

117 million fewer transactions in 2009 than in 2008, adding to the network's overcapacity.

Despite this excess capacity, under current law Post Offices cannot be closed solely for economic reasons.[7] Yet by 2020, with retail revenues predicted to fall by another 40 percent, even more Post Offices will be pushed into the red.

Wages and benefits account for 80 percent of Postal Service costs, and work hours will also become more costly due to rising benefits costs. Total workforce costs are expected to increase from $56.5 billion in 2009 to $77.2 billion in 2020.[8] Workers' compensation is projected to rise by 2 to 4 percent, health insurance premiums by 4.7 to 5.2 percent, and retiree health benefits costs by 11.8 percent. Health care in particular will grow at a pace well above inflation-capped price increases. While the Postal Service has collaborated with its unions to structure reasonable compensation options, federal statutes hamper its ability to craft a market-based benefits package.[9]

Finally, the accelerated schedule requiring prefunding of retiree health benefits over the first 10 years of the 50-year liability will consume $5.5 billion to $5.8 billion per year through 2016. While these obligations will fall to $2.6 billion to $2.7 billion per year from 2017 to 2020, total funding for retiree health benefits will continue to exceed 10 percent of gross revenues through 2020.

III. ACTIONS WITHIN MANAGEMENT CONTROL

The Postal Service will work within current law to close part of the budget gap

The Postal Service evaluated various possible actions for their feasibility and impact on projected losses. The analysis identified four areas with the greatest potential to generate additional revenue and reduce costs under current law. By 2020, these actions are expected to reduce annual losses by $18 billion. Cumulatively, they will narrow the projected $238 billion financial gap by $123 billion. The four areas include product and service actions, productivity improvements, workforce flexibility improvements, and purchasing savings (Exhibit 8).

Exhibit 8: USPS will take a series of actions to save $18 Billion by 2020

Actions within management control:

		Net profit benefit in 2020
1	Product and service actions	~$2B
2	Productivity improvements	~$10B
3	Workforce flexibility improvements	~$0.5B
4	Purchasing savings	~$0.5B
	Avoided interest due to reduced debt	~$5B
	Total	~$18B

As a result of collaboration between management and union leadership, the Postal Service has 200,000 fewer career employees compared to 2000, with the reductions achieved through attrition.

Product and service actions. The Postal Service plans to expand products and services across targeted mail and package segments to increase profits by $2 billion by 2020. For example, it will work to increase direct mail use among small and medium-sized businesses, and to increase volumes in both First-Class Mail and advertising mail through targeted promotions. It will continue to leverage its last-mile network to deliver packages to all households, forming partnerships with others serving the growing e-commerce industry. It will also continue to grow other retail services, such as passports and Post Office Box rentals.

Improving productivity. The Postal Service will continue to cut costs and capture additional productivity savings. Planned actions include further streamlining of plant operations, optimizing delivery routes, providing customer service through the most cost-effective channels, and consolidating administrative functions. Targeted efficiency enhancements will reduce costs by approximately $10 billion in 2020.

Workforce flexibility improvements. Continued attrition due to retirements will provide opportunities to establish a more flexible workforce better aligned with changing customer demand. Over the next 10 years, over 300,000 employees — more than half the current workforce — will be eligible to retire. This will provide an opportunity to make the workforce even more efficient by increasing use of flexible and part-time employees.

Purchasing savings. The Postal Service has additional opportunities to trim resource costs in several areas. For example, it will lower transportation costs by using fewer trips at fuller truck-load levels. It will also continue to negotiate favorable contracts and improve vendor and process management.

In each of these four areas, accomplishing improvements will be exceedingly challenging. For example, the Postal Service has achieved 91 percent automated letter processing, the highest in the world. More than 78 percent of volume is already handled through workshare programs, including presort, destination entry, and automation-compatible mail preparation. In addition, roughly 55 percent of the past savings in work hours were due to reductions in overtime and the non-career workforce. Further opportunity to significantly reduce hours in these areas is very limited.

IV. A VIABLE POSTAL SERVICE: THE PLAN TO GET THERE

The Postal Service is committed to providing universal service to the American people, covering all costs and paying all debts with postal revenue. However, even if it achieves the savings in its management plan, the Postal Service would still face an annual loss of $15 billion in 2020 and cumulative losses of $115 between now and then (Exhibit 9). Further, there is considerable risk that the projected losses could be far greater. And while projections indicate that volumes are likely to fall to 150 billion pieces, alternate scenarios suggest that volumes could sink even lower.

Clearly, aggressive steps are required. That is why the Postal Service is seeking the flexibility to pursue additional opportunities in seven critical areas: 1) retiree health benefits prefunding; 2) delivery frequency; 3) access to services; 4) workforce; 5) pricing; 6) products, and 7) oversight (Exhibit 10).

1. Retiree health benefits prefunding

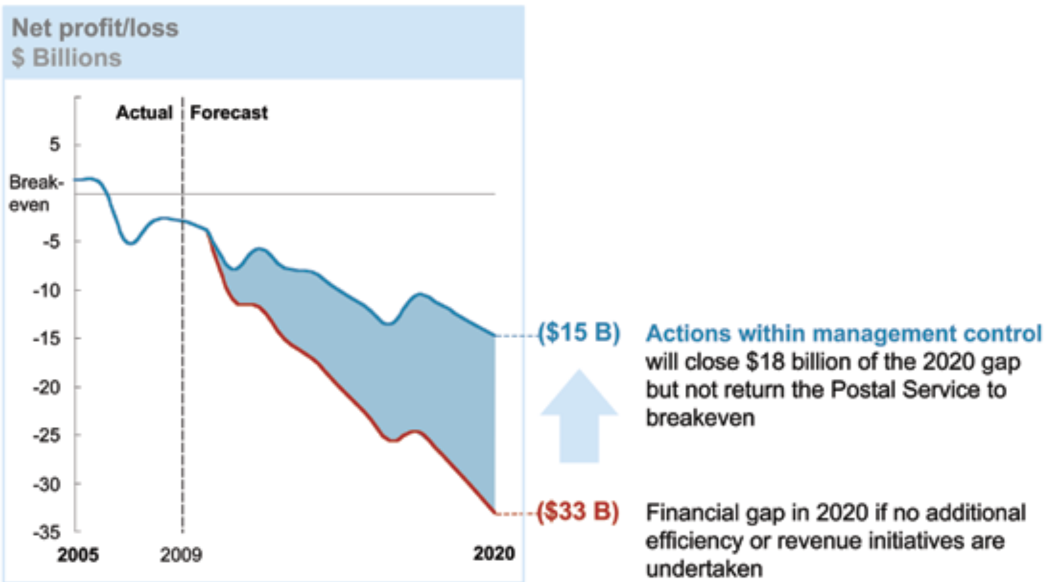
Eliminating the Retiree Health Benefits prefunding requirement would cover only part of the growing financial gap; other changes would still be necessary.

The current retiree health benefits prefunding requirement has a significant impact on postal losses. The Postal Act of 2006 mandated a prefunding schedule of $5.5 billion to $5.8 billion per year through 2016. Congress must approve any future changes to that schedule, as it did in 2009.

The Postal Service seeks to restructure funding in a way that upholds its obligation to current and former employees and does not constrain cash flow during periods of volume decline. To do this, the Postal Service seeks

This crisis provides an historic opportunity to make changes that will allow the Postal Service to succeed as an independent agency of the Executive Branch. Its business model can work if it is recalibrated to 21st century realities.

Exhibit 9: The financial impact of planned management actions



SOURCE: McKinsey analysis

to shift to a "pay-as-you-go" system, paying premiums as they are billed. Other federal agencies and most private sector companies use such a system.

In addition, the Postal Service Inspector General recently determined that the Postal Service overpaid, by nearly $75 billion, its contributions to the Civil Service Retirement System Fund (CSRS). The Postal Service will ask Congress to transfer this $75 billion to the Retiree Health Benefits Trust Fund. When it is added to the Fund's existing $35 billion balance, the Postal Service's retiree health benefits will be fully or nearly fully funded. As much as $50 billion can be saved over the next 10 years if the Postal Service does not have to prefund retiree health benefits.

Exhibit 10: Postal Service of the future

Today Limited ability to respond to market changes → **Tomorrow** Flexibility to respond quickly to evolving market

	From	To
Retiree health benefits	▪ Pre-funded retiree health benefits requirement	▪ "Pay-as-you-go" retiree health benefits in line with other government institutions
Delivery frequency	▪ Mandated 6 day delivery regardless of changing volume	▪ Flexibility to adjust delivery frequency to match volume and changing customer needs
Access	▪ Primarily 9am-5pm brick-and-mortar Post Offices	▪ Expanded access through an enhanced online presence, partnerships, and kiosks
Workforce	▪ Limited flexibility to adapt to market and technology changes	▪ Flexibility to capture natural attrition to match changing demand
Pricing	▪ Strict inflation-based price caps by class	▪ Flexible pricing reflecting market dynamics
Products	▪ Restricted to postal products	▪ Flexibility to introduce additional products consistent with broader mission
Oversight	▪ Multiple bodies with overlapping roles and responsibilities and lengthy processes	▪ Streamlined approach to oversight

2. Delivery frequency

To adapt to changing mail volumes and consumer needs, the Postal Service must have the authority to reassess and adjust the frequency of delivery. A recent Gallup survey showed that two-thirds of Americans would rather have delivery days reduced than have increases in postage or have the government subsidize the Postal Service's losses with taxpayer funds (Exhibit 11).[10]

The Postal Service would move to a 5-day per week schedule if given the legislative changes required to adjust delivery frequency, thus eliminating delivery on Saturday, the lowest volume day. This would boost 2010 daily delivery volumes per address to 2008 levels. This would also help close a substantial portion of the net income gap, yielding annual savings (after initial implementation) of approximately $3 billion in 2009 dollars.

3. Access

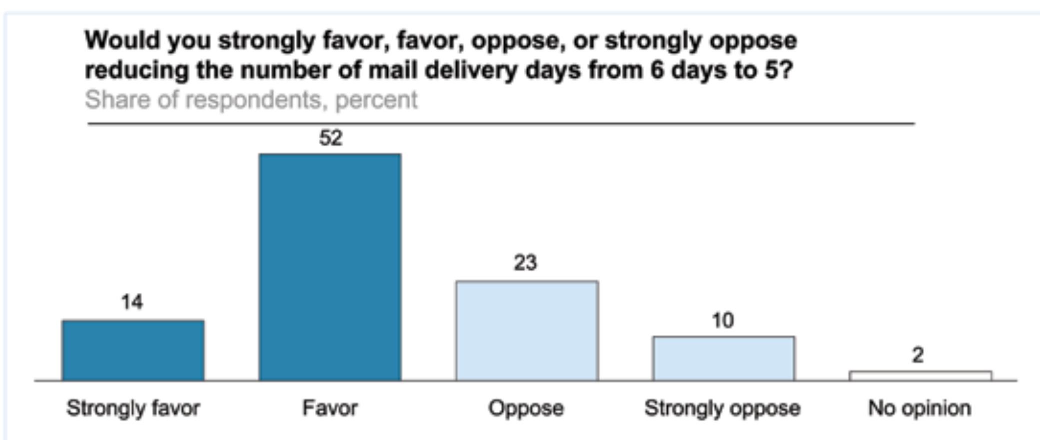
As consumer behaviors and needs change, so must the Postal Service. It must better align its retail network and the access it provides, investing in new options that improve service while lowering costs. Access will be expanded by serving customers where they already shop, creating more automated and on-demand services such as stand-alone kiosks and additional partnerships with retailers. The Postal Service will expand options available on its website and through its carriers, which provide access to most postal services without customers leaving their home or office.

As customers continue to shift to these new services, the Postal Service will minimize costs by reducing redundant retail facilities. Current customer research shows increased demand for new ways to access the postal services. For instance, 79 percent of Americans surveyed were not concerned about closing Post Offices if postal services were moved to other retail locations (Exhibit 12). Many actually preferred to have postal services provided in nearby retail locations rather than Post Offices.

Proposals to close facilities often lead to protests, and on a few occasions Congress has blocked changes through legislation. This response is not unique to situations involving the Postal Service. For example, recommendations to close or consolidate military installations have also met with resistance. However, because the Postal Service does not receive appropriated funds to maintain its network, postal customers are ultimately required to absorb the costs of political decisions that keep redundant facilities open.

Given the need for dramatic cost reductions, the American public is most in favor of eliminating Saturday delivery, rather than taxpayer subsidies or significant price increases.

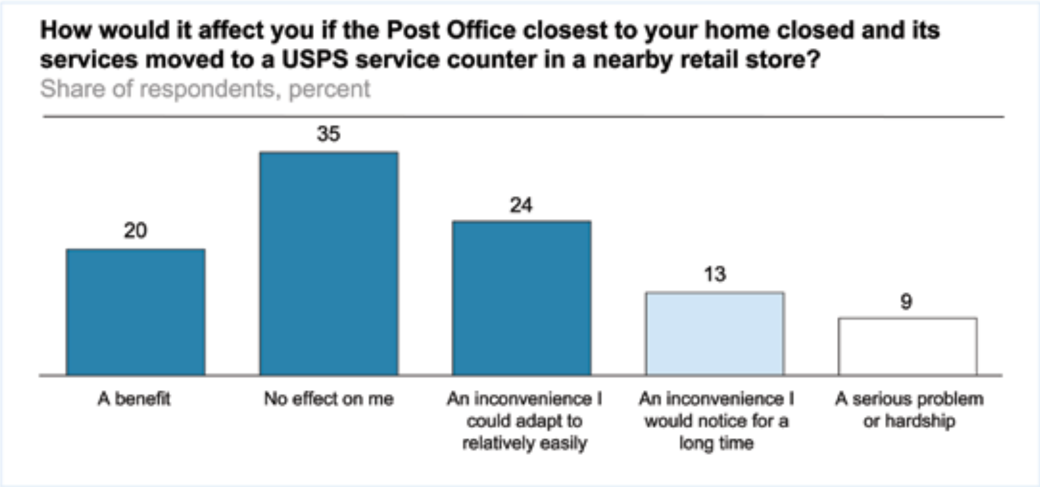
Exhibit 11: Public opinion regarding delivery frequency



SOURCE: Gallup Poll June 17-18, 2009

Almost 80 percent of consumers report they would benefit or would easily adapt if Post Office services were moved to a nearby retail store.

Exhibit 12: Survey Data: Consumer acceptance of retail service options



Note: Numbers do not sum due to rounding
SOURCE: Consumer survey, December 2009, conducted by McKinsey

4. Workforce

The Postal Service must become a leaner organization. The large number of expected retirements creates an important opportunity to achieve this through what can be an orderly process of attrition, and by establishing more flexible work rules through the collective bargaining process. Annually, approximately 5 percent of employees are eligible and expected to retire. It would not make sense to replace them with full-time employees if demand is moving in a direction better suited to a part-time workforce. Although the Postal Service would prefer to manage this change through collective bargaining, under existing law, arbitration is always a possibility. The financial health of the Postal Service and the affordability of postal products should be key considerations in any arbitration ruling. Therefore, the Postal Service will ask Congress to require arbitrators take into account its financial condition before making any decision.

When benchmarked against other large posts, the Postal Service employs the most full-time workers as a percentage of the total workforce. For example, the United Kingdom employs 22 percent part-time employees and Deutsche Post employs 40 percent part-time employees, while part-time employees represent up to 13 percent of this country's postal workforce. Providing increased workforce flexibility will help maintain service levels while reducing costs.

5. Pricing

The Postal Service needs the authority to adjust its pricing to better reflect market dynamics and offset future volume and revenue declines. Current law does not provide this. Instead, prices by class remain tied to CPI, and not to the key drivers of postal inflation. Also, the Postal Service may make only limited price increases under exigent circumstances. Therefore, it will seek legal modifications related to pricing, and pursue a moderate exigent price increase effective in 2011.

Single price cap. The first reform would apply the inflation price cap to Market Dominant products as a whole, rather than to each class of mail. This would allow adjustment of individual prices based on market demand and unit costs. Prices for some classes would rise above the rate of inflation while others would rise at a lower rate. This would provide flexibility over time to address products that do not currently cover their costs.

Preferred-class pricing. Addressing the pricing of preferred mail — such as non-profit mail, Media Mail, Library Mail, and Periodicals — would ensure that these products get to a point where they cover costs while contributing reasonably to overhead costs. An alternative would be appropriations funding to cover the gap.

Exigent price increase. The Postal Act of 2006 allows price increases beyond the Consumer Price Index in extraordinary circumstances. Such increases are permitted if the Postal Regulatory Commission finds "that such adjustment is reasonable and equitable and necessary," and that there are "exceptional or extraordinary circumstances."[11] Using existing authority, the Postal Service will pursue a moderate exigent price increase in 2011. Larger increases will need to be pursued if changes are not authorized in connection with other issues, such as Retiree Health Benefits pre-payments and 5-day delivery. Given the largest volume declines since the Great Depression, the requirement to pre-pay billions of dollars in retirement health benefits, and the forecast for increasing net losses, among other unfavorable realities, the current situation should qualify (Exhibit 13).

6. Products

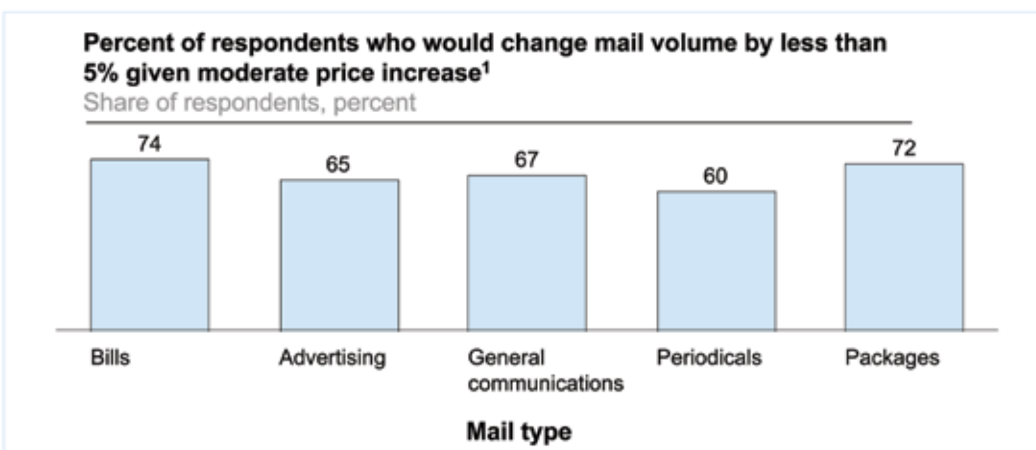
As technology and customer needs change, so will the definition of mail. The Postal Service seeks additional flexibility to innovate its products and better meet changing customer demands, while tapping into new sources of revenue.

Currently, every potential new product, including individual customer contracts, require before-the-fact review by both the Governors and the Postal Regulatory Commission. The existing review process can delay the implemention of customer contracts, leading to mailer frustration and providing an advantage for competitors.

Amending the current regulatory framework to broaden the definition of postal products and allow for streamlined, after-the-fact product reviews would allow the Postal Service to introduce new products and services in a more timely and customer-friendly way.

Although prices are capped by law, survey data show that small businesses would tolerate moderate increases.

Exhibit 13: Survey Data: Small business response to price increase



1. 5% price increase

SOURCE: Consumer survey, December 2009, conducted by McKinsey

7. Oversight

Congress modified the Postal Service's oversight model in 2006 at a time when volumes were increasing. The model includes Presidentially-appointed Governors (USPS) and Commissioners (PRC). Both are required to represent the public interest and have overlapping responsibilities to ensure affordable, quality, universal service to America. Additional oversight includes Congress, portions of the Executive Branch, the Government Accountability Office, the Postal Service Inspector General, and other federal agencies. In many situations, roles and responsibilities overlap and are not sufficiently clear. Oversight primarily involves changes to postal networks, products, prices, costing methods, service, Sarbanes-Oxley Act Compliance, and complaints.

The world is rapidly changing, yet the current oversight model constrains the flexibility and speed required to adapt and respond. It is crucial to clarify oversight roles and responsibilities and to streamline processes. Oversight changes are critical mechanisms to make this plan a reality. Since the Postal Act of 2006, the Postal Service has increased transparency and accountability. However, internal changes alone are insufficient. Changes in law are necessary to make oversight processes more responsive to market needs. They should include looking at issues such as time limits on reviews, and moving before-the-fact to after-the-fact reviews. Collectively, these changes would ensure continued protection of customer interests while providing flexibility to manage in the changing postal environment.

Only by balancing actions across all these areas will the Postal Service be able to eliminate the deficit projected for 2020 and continue to provide high quality, affordable service. Limited action on just a few areas would exacerbate the Postal Service's financial situation and place an undue burden on postal stakeholders.

THE PATH FORWARD

Even with the most informed projections, there is no way to know exactly what the future holds. Therefore, it is imperative that improvements to the Postal Service business model contain sufficient flexibility to allow the Postal Service to respond quickly in a financially responsible way no matter where the market turns. America can continue to enjoy quality, universal postal service at no cost to the taxpayer only if aggressive internal improvements are made in tandem with regulatory and legal changes.

The only way to close the Postal Service's income gap while providing the American people with the service they deserve is though a balanced approach that does not overtax any single part of the business or place a disproportionate burden of change on any one group. The Postal Service asks for the flexibility necessary for action along all seven proposals:

- Restructuring retiree health benefits payment to a pay-as-you-go system
- Adjusting delivery frequency to reflect volumes and customer needs
- Modernizing access to make it more effective and efficient
- Establishing a more flexible workforce
- Aligning pricing with economic realities
- Allowing faster introduction of a broader range of products
- Ensuring agile and appropriate oversight

If this plan becomes a reality, the Postal Service can build on its achievements and secure a strong future to meet the nation's changing needs. Delay increases the challenge and deepens the crisis. Success will require starting to work on solutions now.

Appendix

Summary of some of the additional concepts that were evaluated but are not currently being pursued

Changing First-Class Mail service standards

Moving First-Class Mail service standards from 1-3 days to 2-5 days would reduce cost and system complexity. Savings would accrue by consolidating facilities and divesting unused plants, virtually eliminating costly air transportation, and redesigning the network to simplify and standardize mail flows and processes.

The option to lengthen the delivery window for First-Class Mail will not be pursued at this time. When presented with this prospective change, mailers expressed concern about the cash flow consequences of a longer delivery window for bills and payments. Only 17—18 percent of consumers responded that a shift from 1- to 2-day local mail would be "an inconvenience I would notice for a long time" or a "serious problem or hardship." Nevertheless, mailers said they would likely reduce volumes if the standards changed. There is already a shift from First-Class Mail to Standard Mail due to its improved service. Reducing the First-Class Mail service standard would no longer provide the same level of product differentiation, thereby reducing the value of First-Class Mail.

Shifting delivery to the curb or centralized boxes

Moving delivery from the door to a curb receptacle, or from the curb receptacle to a centralized "cluster box," would reduce costs by allowing for more deliveries per route. This option will not be pursued at this time. Mailers were concerned that shifting delivery to curb or community mailboxes would undermine the convenience and intimacy of mail and lead to customers checking mail less frequently. They said they would reduce volumes as a result. Roughly 15 to 20 percent of small and mid-sized businesses expected to reduce volume by more than 10 percent if delivery points were changed. Higher-volume mailers responded similarly. Shifting delivery points would also be expensive and slow to implement.

Additional non-mail revenue generating options

Additional revenue opportunities will continue to be considered in the future. Some product ideas were drawn from international posts, which take a broad-based approach to product diversification. Ultimately, five areas stood out — parcel services, logistics, banking, integrated marketing, and document management. Building a sizeable business in any of these areas requires time, resources, new capabilities (often with the support of acquisitions or partnerships), and profound alterations to the postal business model. Accenture research shows that while international posts are still building these businesses and implementing the necessary steps to make them succeed, these lines of business tend to generate below-average profitability compared to industry benchmarks. (Details on *usps.com*.)

However, the other product areas examined are currently not viable for the Postal Service because of its net losses, high wage and benefits costs, and limited access to cash to support necessary investments. Opportunities to leverage the Post Office network to enter new markets, such as banking or consumer goods, are similarly limited by high operating costs and the relatively light customer traffic of Post Offices compared to commercial retailers.

Becoming a federal government agency supported by appropriations

The Postal Service examined other business models, including a switch from today's self-funded Postal Service to a regular federal government agency supported by appropriations. This would be similar to the structure prior to the Postal Reorganization

Act of 1970. Under this model, Congress would determine the level of service provided, including the definition of universal service, pricing, and facility closures.

This model eliminates the tension that exists between the Postal Service's status as a governmental agency and its mandate to be self-supporting. This business model also ties political decisions to the funding responsibility for those decisions. For example, if Congress does not want facility closures, it would have to continue to fund those facilities.

The main disadvantage is taxpayer burden, especially given the deficits in the current economic environment.

Moving towards privatization

Another business model option evaluated was privatization. This would be a dramatic measure requiring sweeping changes. The Postal Service would cease to be a government agency, and would operate as a private business owned by investors. This new private post would have shareholders and would compete with other private businesses. The postal monopoly would be reduced or eliminated. The Postal Service would be free to enter into any other businesses it saw fit, and it would be allowed to fail.

This model allows for greater flexibility in both revenues and costs. The Postal Service would have the ability, without political interference, to right-size its networks, design pricing approaches, adjust delivery frequency, and determine which products to eliminate or add. Those who support privatization point to the economic efficiencies of allowing market supply and demand to determine pricing and services offered, and to the assumption that competition would likely give rise to innovation and a more agile customer-responsive entity.

A look at privatization in other countries shows prices far greater than in the United States. A new private post could lose economies of scale inherent with processing and delivering the entire nation's mail. Presumably, other postal providers will quickly move in to serve the higher volume, profitable areas of the country, leaving higher cost rural and inner city urban locations without affordable service. To ensure universal service, subsidies would be required either through tax dollars or universal service fees charged to licensees. Nationwide affordable and uniform pricing would likely be eliminated, since private businesses would charge more to deliver to higher-cost areas. Elimination of the mailbox monopoly may raise concerns about the safety and security of the mailbox. Perhaps most importantly, there is the question of whether the Postal Service could find investors and equity if privatized, given that it has negative equity, operates in a declining industry, and is burdened with significant outstanding liabilities. Therefore, all the changes laid out here would be needed before privatization.

Endnotes

1. The Boston Consulting Group projected mail volumes through 2020. Accenture analyzed the range of businesses that foreign posts have entered to see if these could raise profitable revenue to support the USO. McKinsey & Company developed an independent assessment of the Postal Service's current strategies and provided recommendations for future growth and cost savings options, over a ten year period.

2. $15.8 billion loss in revenues reflects aggregate volume decline (from 2006—2009) against 2009 prices.

3. Includes only the prefunding amount, not the costs of premiums for current retirees.

4. Price caps apply to Market Dominant products, including First-Class Mail, Standard Mail, Periodicals, Bound Printed Matter, Media Mail, Library Mail, and Special Services. In aggregate, they account for 88 percent of revenue and more than 99 percent of volume.

5. Volume projections based, in part, on extensive mailer interviews, consumer surveys and interviews, experience with other posts, and insight into other industries. Analysis developed by The Boston Consulting Group.

6. Daily revenue per delivery point was calculated by dividing revenue by the number of delivery points and annual delivery days. Revenue is not adjusted for inflation. (This endnote is revised from an earlier printing of this paper).

7. "The Postal Service shall provide a maximum degree of effective and regular postal services to rural areas, communities, and small towns where Post Offices are not self-sustaining. No small Post Office shall be closed solely for operating at a deficit, it being the specific intent of the Congress that effective postal services be insured to residents of both urban and rural communities." [39 U.S.C. 101(b)]

8. Assumes no action is taken to reduce workforce costs by 2020.

9. Regulations prevent the Postal Service from settling workers compensation claims (20 C.F.R. 10.5) and, unlike in most other industries, the Postal Service gets no subsidy to cover the costs for Medicare Part D prescription drugs. By law, the Postal Service may not have "a program of fringe benefits" that "on the whole" is less favorable than on July 1, 1971. [39 U.S.C. 1005(f)]

10. Sixty-six percent of consumers were reported to "strongly favor" or "favor" 5-day delivery over other options, including taxpayer subsidies, higher prices, lay-off of postal employees, and closing Post Offices.

11. P.L. 109-435 (Postal Act of 2006).

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Year References

All references to a specific year or "the year" refer to the Postal Service fiscal year ending September 30. However, specific month and year references pertain to the calendar date.

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