

# The Need For Transformation



## Section 1 — The Need for Transformation

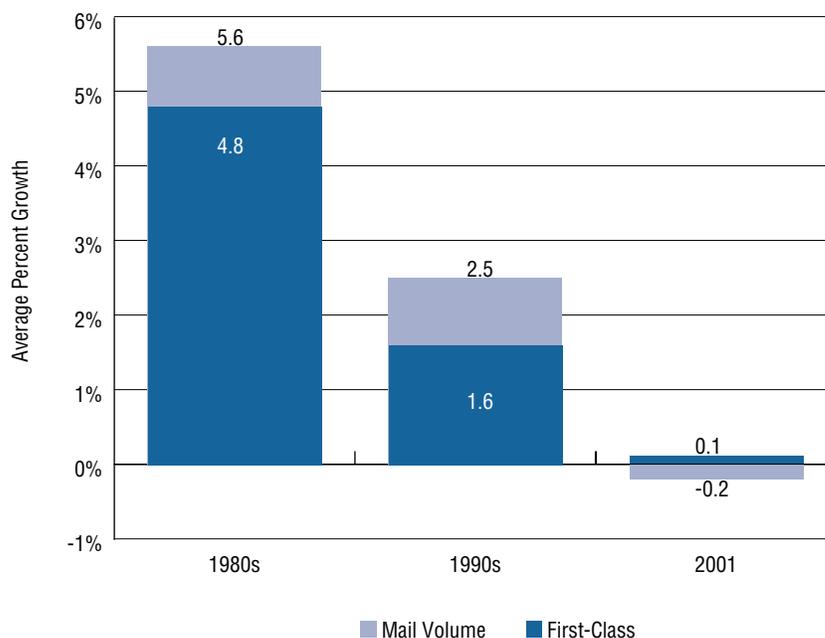
When Congress enacted the Postal Reorganization Act (PRA) of 1970<sup>1</sup> and established the Postal Service as an independent, self-supporting federal entity, the legislation rectified a service crisis marked by inconsistent delivery and widespread public dissatisfaction. The new Postal Service was to meet its responsibilities in a businesslike fashion by ensuring that revenues from the sale of products and services were sufficient to cover all operating costs.

For three decades, the Postal Service has served the nation well. It has maintained universal service, improved service quality, and held postage rate increases to levels commensurate with inflation. Nonetheless, because of sweeping changes in technology and business practices, the institution is facing a vastly different commercial environment than it did in 1970. As a result of these macroeconomic changes, the rate of growth in mail volumes has been declining since 1997. In 2001, the total volume of mail decreased slightly, following a general downturn in the economy. Facing both weaknesses in the economy and terrorist attacks, in the first half of fiscal year 2002 the Postal Service saw its largest mail volume decline since the Great Depression.

*If I've learned nothing else as Postmaster General, I have become convinced that we cannot allow the Postal Service to drift toward the crises of the 1960s that ultimately compelled postal reform in 1971. We have to make some very fundamental, critical changes. We have to come to grips with the reality that the legislation that created the Postal Service more than 30 years ago now puts us out of step with our customers, our competitors, and the marketplace. You and I both know, today we are unable to respond effectively in the highly competitive marketplace of the 21st century.*

—Postmaster General John E. Potter,  
address to National League of  
Postmasters, February 25, 2002

### VOLUME GROWTH BY DECADE



Source: Postal Service Internal Records

<sup>1</sup>Postal Reorganization Act, Title 39, U.S. Code, Sec. 101 (a).

In April 2001, the General Accounting Office (GAO) placed the Postal Service's transformation efforts and its long term outlook on its "high risk" list to focus attention on challenges facing the organization. Subsequently, in June, Congress asked the Postmaster General to prepare a plan that would address the structural reform of the organization. On September 30, 2001, the Postal Service published the *Outline for Discussion: Concepts for Postal Transformation*, which established the framework for a comprehensive discussion among Postal Service stakeholders.<sup>2</sup> The process of input, analysis, and discussion that followed resulted in this *Transformation Plan*. The transformation planning effort has been led by the Postal Service's Board of Governors, the Postmaster General, and Executive Committee and conducted by a cross-functional postal management team.

This *Plan* is presented in four chapters:

- **The Need for Transformation.** Presents the case for change.
- **Meeting the Challenge.** Identifies actions the Postal Service is taking now and the moderate regulatory and legislative changes needed to enable those actions.
- **Preparing for the Future.** Discusses potential future business models, the Postal Service's recommendation, and the statutory changes required.
- **Conclusion.**

This chapter describes the challenges the Postal Service faces and the perspectives of postal stakeholders on transformation issues.

## 1.1 Reasons for Transformation

In 2001, the Postal Service delivered 207 billion pieces of letter mail, periodicals, advertising mail, and packages to approximately 138 million addresses six days a week. This volume represents over 40 percent of the world's mail. In one week, the Postal Service delivers the same volume that United Parcel Service (UPS) delivers in a year; and in two days, the Postal Service delivers the same volume that FedEx delivers in a year.<sup>3</sup>

Measured by revenue, the Postal Service is the 11th largest domestic enterprise and the 33rd largest worldwide.<sup>4</sup> It receives virtually no taxpayer dollars, charges among the world's lowest prices for letter mail,<sup>5</sup> and anchors a \$900 billion domestic mailing industry.<sup>6</sup> With nearly 770,000 career employees, the Postal Service is the second largest civilian employer in America after Wal-Mart.<sup>7</sup> When combined with private sector employees in the mailing industry, 1 in 15 American workers makes a living from a postal-related job. These employees and private businesses in turn contribute to the American economy. In 2001, the Postal Service's payroll, excluding benefits, totaled

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<sup>2</sup> See Appendix B, Executive Summary of *Outline for Discussion*, for more information. To read the full report, go to [www.usps.com/strategicdirection](http://www.usps.com/strategicdirection).

<sup>3</sup> To see the *U.S. Postal Service 2001 Annual Report*, go to [www.usps.com/history/anrpt01/](http://www.usps.com/history/anrpt01/).

<sup>4</sup> See Tables 1 and 2 in Appendix A, *Charts, Graphs, and Tables*, for more information.

<sup>5</sup> See Chart 1 in Appendix A, *Charts, Graphs, and Tables*, for more information.

<sup>6</sup> The growth of the U.S. mailing industry resulted in large part from the flexibility gained by the Postal Service under the Postal Reorganization Act of 1970 and is one of the major success stories of that legislation. Further information on the composition, scope, and concerns of the mailing industry can be found in Appendix C, *Overview of the Mailing Industry*.

<sup>7</sup> See Table 3 in Appendix A, *Charts, Graphs, and Tables*, for more information.

\$38 billion. In that year, the Postal Service spent \$17.8 billion on supplies and services, nearly \$1 billion in rent, and \$64 million in taxes on leased facilities. Clearly, the postal industry is vital to America's citizens and its commerce. Given the breadth and scope of this industry and the significant role it continues to play in the economy, why should the Postal Service change?

As the GAO has indicated, financial losses in the last three years and volume losses in the last 18 months raise questions about the viability of the current business model. The Postal Service believes there are two cogent and fundamental reasons for revising the legal framework of the organization. First, three decades of experience with the Postal Reorganization Act of 1970 indicate that the charter of the Postal Service should be modified to serve the ongoing needs of the nation more efficiently and effectively. While the basic charter of the Postal Service has remained static since its inception in 1970, the mailing industry and private sector delivery companies have evolved to meet the changing needs of the marketplace. Indeed, innovation and competition were not primary concerns of the 1970 Act. The Act was designed to allow the Postal Service to do what it did in 1970 in a more businesslike manner. By definition and structure, a government entity has goals and mandates that the private sector does not have, and these inhibit the flexibility needed for direct competition. In the far different and more competitive environment of 2002, a revision of the Postal Service's 1970 charter is overdue.

The second, and ultimately more important, reason for transformation is that the future will not be like the past. In a number of possible future scenarios, the Postal Service may soon find itself increasingly ill-equipped to serve the postal needs of the nation. While the precise shape of the future cannot be known, an inventory of global economic changes impacting the Postal Service is sobering: a potentially sharp decline in mail volume, a major increase in costs due to security and other factors, and consolidation of operators and markets into global delivery services. If these developments persist—and governments of many industrialized countries that have studied these issues say they will—future postal success will require a more flexible institution with the organizational adaptability and managerial tools of commercial businesses. While such flexibility may possibly prove unnecessary (the future may resemble the present), it will be impossible to transform an organization the size of the Postal Service once the future has arrived.

From these twin perspectives, the major drivers of transformation are summarized below.

### **Potential Declines in First-Class Mail® Volume**

As indicated above, the rate of growth of total mail has been declining since 1997, turning slightly negative in 2001. Single-piece, First-Class Mail volumes have declined for four straight years, with a 2.7 percent decrease in 2001. This mail category includes bill payments, which are especially vulnerable to diversion. Postal Service models indicate that electronic diversion is the largest contributing factor driving the decline in First-Class Mail, single-piece letters.<sup>8</sup>

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<sup>8</sup> See Docket No. R2001-1, USPS-T-7, Testimony of George Tolley, page 37, [www.prc.gov](http://www.prc.gov).

## IMPLICATIONS ON COST COVERAGE

A decline of \$1 Billion in Single-Piece First-Class Mail (FCM) results in a lost contribution of \$432 Million.

	Volume (Thousands)	% Change
FCM Single Piece	(2,403,846)	(4.6%)
Offsetting Increases*		
Standard Mail	7,078,689	7.9%
or Priority Mail	313,353	25.6%
or Express Mail	49,609	69.9%
or Parcel Post	1,509,790	465.7%

\* Making up the lost contribution would require an increase in the amounts noted above.

Source: Postal Service Internal Records, FY 2000 *Cost and Revenue Analysis*.

*The electronic "diversion" of mail volumes, particularly of First-Class Mail, directly impacts the Postal Service. While conventional wisdom places the Postal Service directly at risk from this "new economy," the actual impact on mail remains unknown. Appendix E, Electronic Diversion of Mail Volumes, provides an economic review of the diversion issue.*

Mail volumes were down significantly following the terrorist and anthrax attacks in the fall of 2001. While that volume decline cannot be attributed to electronic diversion, only time will tell whether the loss is temporary, or whether the events of last September and October have accelerated the rate of adoption of alternatives to the mail. Overall, it is dangerous, in the words of a large postal stakeholder group, to assume that mail volume will continue to rebound with the economy.<sup>9</sup> Given the growing volatility of mail volume, there is an urgent need to build flexibility into the postal model.

The Postal Service's financial condition is particularly sensitive to the volume of First-Class Mail. First-Class Mail comprises 48 percent of total mail volume and 69 percent of total contribution.<sup>10</sup> In other words, First-Class Mail covers more than two-thirds of institutional costs, that is, costs such as those related to the network of post offices and delivery points. A substantial reduction in First-Class Mail volume would mean that the contribution this class makes to institutional costs would have to be made up by decreases in operating costs, increases in other class volumes, increases in rates, and/or a change in the universal service obligation. Offsetting losses from the crucial First-Class Mail contribution to overhead with increased contribution from other postal products and services is unlikely.

## Increasing Cost Burdens

Despite significant gains in efficiency and productivity through automation, Postal Service costs are rising faster than revenues.

Most postal employees are covered by collective bargaining and are paid an average wage/benefit premium in excess of comparable private sector wages and benefits. The vast majority of current postal labor requirements are inextricably tied to infrastructure issues, such as the postal retail network and the rising number of delivery points. Significant reductions in labor costs cannot be achieved without addressing these issues.

In 2001, compensation and benefits accounted for 76 percent of total Postal Service expenses. These costs increased 3.7 percent over the previous year. Postal Service employees are covered under the federal Civil Service Retirement System (CSRS), the

<sup>9</sup> See Charts 2A and 2B in Appendix A, *Charts, Graphs and Tables*, for more information.

<sup>10</sup> See Chart 3 in Appendix A, *Charts, Graphs and Tables*, for more information.

Dual System, or the Federal Employees Retirement System (FERS). Coverage is based upon the starting date of employment with the Postal Service. Employees may also participate in the Thrift Savings Plan, which is a defined contribution retirement savings and investment plan. Postal Service retirement and health benefit costs will continue to escalate over the next 10 or more years due to the overlap in funding requirements under the retirement systems that cover current employees and postal annuitants.<sup>11</sup> Annual operating expenses for retirement costs, including annuitant health benefits, are anticipated to grow from \$9.7 billion in 2001 to \$15.8 billion in 2011. Further, increases in the number of Postal Service retirees, the growth in annuitants' health benefits, and cost-of-living adjustment costs will continue to escalate. Finally, not until all employees fall under FERS retirement will these costs stabilize.

Another area of significant cost is the current employee dispute resolution process. The Postal Service currently has overlapping and duplicative processes for employees to file complaints concerning workplace disputes. This generates excessive administrative expense associated with managing these processes.

### Significant Fixed Costs

The “everywhere, every day” universal service obligation requires a significant infrastructure investment. Almost one-half of total postal costs are spent on fixed costs. The “everywhere” responsibility requires the provision of service to the ever-increasing number of delivery points. The Postal Service adds 1,700,000 new addresses annually and there is a significant cost of providing this additional service. These new delivery addresses necessitate the addition of 4,800 new carriers to make delivery to over 513,000,000 new delivery stops each year. Additional fixed costs, such as those associated with vehicles and facilities, are incurred to support this growth. In the past, the annual growth in mail volume has served to offset the cost of providing new service, but that is no longer the case.

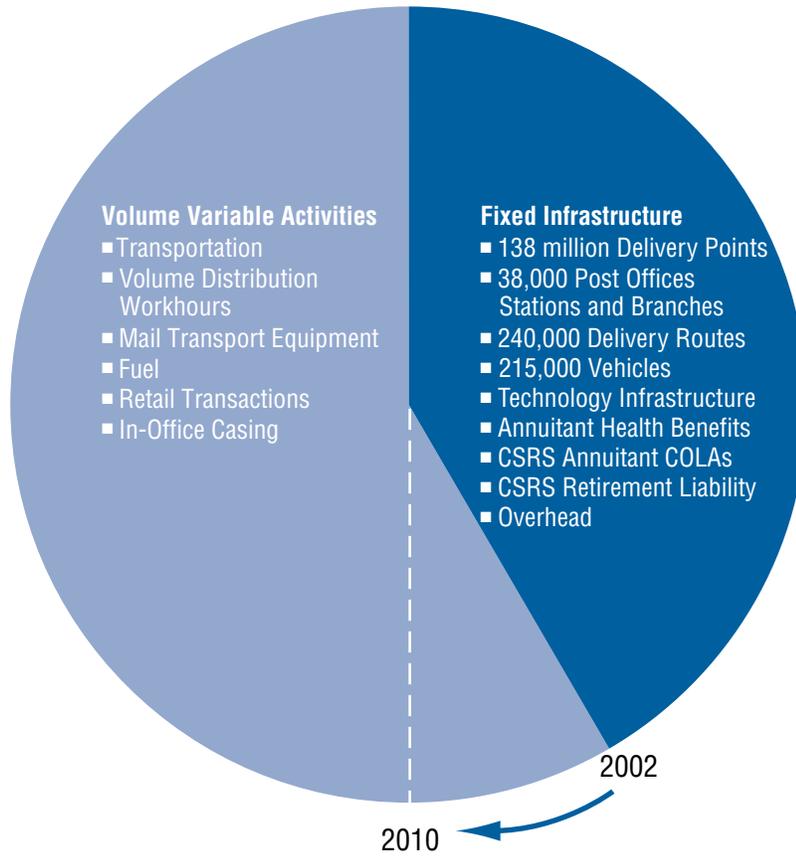
The “every day” portion of the universal service obligation also contributes significantly to the level of fixed costs. An enormous infrastructure is necessary to support postal operations. A significant portion of postal costs is spent on fixed resources and does not increase or decrease when volume changes.<sup>12</sup> Letter carriers travel their complete routes, trucks transport mail between facilities each day to meet service commitments, and retail facilities are open each business day no matter what level of activity occurs. As the Cost Trends chart illustrates, nearly one-half of all postal costs are fixed, and their proportion of total cost will continue to increase. This includes more than 38,000 post offices, stations, and branches, 240,000 delivery routes to service over 138,000,000 delivery addresses, 215,000 vehicles, and significant annuitant retirement costs.

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<sup>11</sup> See Appendix D, *Escalating Retirement Costs*, for more information.

<sup>12</sup> See Appendix F, *Fixed Versus Variable Costs*, for more information.

**COST TRENDS — FIXED VERSUS VOLUME VARIABLE COSTS**



FY 2001 Total Expense \$67.5 Billion

Source: Postal Service Internal Records

**Expanding Communications Alternatives**

The Internet and the World Wide Web, not even invented in 1970, have dramatically changed the communications market.<sup>13</sup> Within the next decade further innovations such as mobile commerce, broadband, interactive TV, data mining software, and new printing technologies will change the way businesses and consumers interact. While hard copy mail retains tremendous effectiveness, there is little doubt that its share of the overall communications market will shrink.

Of greatest impact on the Postal Service are electronic alternatives to business correspondence and transactions, particularly for First-Class Mail items such as bills, statements, and payments.<sup>14</sup> First-Class Mail volumes have already been affected by the telephone, fax machine, Internet, and other electronic communications, including online bill presentment and payment, bill payments by telephone, electronic filing of tax returns, direct deposit of tax refunds, Social Security payments, and other government transactions.

<sup>13</sup> See Chart 4 in Appendix A, *Charts, Graphs, and Tables*, for more information.

<sup>14</sup> See Chart 5 in Appendix A, *Charts, Graphs, and Tables*, and Appendix E, *Electronic Diversion of Mail Volumes*, for more information.

The Internet is also forcing the Postal Service into greater competition with the private sector by changing the mix of mail. The Internet and electronic commerce are stimulating growth for other postal products, such as package delivery and targeted ad mail. These products are subject to competition from traditional sources (e.g., newspaper and TV ads and other package delivery firms).

### Aggressive Competition in Postal Markets

The Postal Service is losing share in the overall delivery services market.<sup>15</sup> Giant corporations now dominate parcel and express markets. Other companies, such as consolidators and presort bureaus, have invested significantly in the upstream worksharing portions of postal processing and could develop into major competitors in the future.

Competitors such as UPS and FedEx are expanding into other businesses, including an increasing portion of the postal value chain. For example, UPS has entered the “hybrid” mail market, where messages are generated electronically and printed close to the final destination. UPS also recently entered the presort business. Under the current regulatory structure, competitors have far more flexibility to respond to changes in market conditions and to target specific customers than does the Postal Service. Should the Postal Service continue to lose ground in competitive markets, the loss of valuable revenue will jeopardize its ability to fund universal service.

### Increasing Competition from Global Delivery Service Providers

The global competitive landscape for posts is changing irreversibly.<sup>16</sup> With the rise of multinationals, deregulation, and free trade agreements, international posts have followed the airline, telecommunications, public utilities, trucking, bus, rail, and steel industries to less regulated, more competitive markets. The liberalization of the European Union (EU) provides economies of scale for former national postal services to emerge as global enterprises offering a wide variety of services. Liberalization of posts in Canada, Asia, and Latin America expands the competition.

Foreign postal operators such as Deutsche Post World Net (DPWN) and TNT Post Group (TPG) are moving well beyond traditional postal services, offering logistics, financial services, and electronic services. Four foreign posts—DPWN, TPG, Consignia (United Kingdom), and La Poste (France)—have limited operations in 18 major metropolitan centers nationwide, including New York, Boston, Washington, DC, Houston, Salt Lake City, Los Angeles, San Francisco, and Seattle. These operations feature some sales offices and offer mail, parcel, logistic, and financial services to the American market.<sup>17</sup> DPWN recently acquired a controlling interest in DHL, the leading global express company, originally a U.S. firm. DPWN owns one of the largest global freight forwarders, also based in the United States. In addition,

*Additional information on global competitors of the Postal Service, including financial information, presence in the United States, and scope of global operations can be found in Appendix G, Global Postal Competitors in the United States.*

<sup>15</sup> See Chart 6 in Appendix A, *Charts, Graphs, and Tables*, for more information.

<sup>16</sup> See Appendix H, *Postal Transformation: The International Experience*, for more information.

<sup>17</sup> See Chart 7 in Appendix A, *Charts, Graphs, and Tables*, for more information.

DPWN has created its own Philadelphia-based top management training school, Deutsche Post World Net University, in partnership with the University of Pennsylvania's Wharton School.<sup>18</sup>

Outside the United States, the delivery services sector is likely to be characterized by continuing regulatory reforms, cross-border acquisitions and alliances, and new product development. Playing an important role in this process is the Universal Postal Union (UPU), an intergovernmental organization consisting of 189 countries. Until 1998 the Postal Service had the lead responsibility for representing U.S. interests at the UPU. That role has been transferred to the State Department. Changes in the structure and direction of the UPU will impact the Postal Service both at home and abroad.<sup>19</sup> A strong partnership with and representation by the State Department will continue to be important for Postal Service success in this area.

As foreign posts enter more and more of the U.S. postal value chain, the loss of revenue experienced by the Postal Service could potentially put the provision of universal service in deeper peril.

## 1.2 Perspectives on Transformation

Stakeholders in the United States Postal Service offered comments on postal transformation through an outreach program that included discussion proposals, Web-based and traditional mail channels, focus groups and public surveys, stakeholder group meetings, Board of Governors-directed panel discussions, and employee surveys. To ensure that stakeholders had ease of access and a context for commentary, the Postal Service published two *Federal Register* notices and a report titled *Outline for Discussion: Concepts for Postal Transformation*. Analysis of the commentary and input received suggests broad stakeholder agreement on the following themes:

- Postal Service transformation is necessary and desirable.
- Transformation should get underway as soon as possible.
- The Postal Service should take a leadership role, rather than wait for others to solve its problems.
- Universal service must be maintained, although not necessarily in its current form.
- The Postal Service should continue to emphasize secure, accessible and affordable delivery.
- There is no clear mandate for full privatization of the Postal Service.

Within the distinct segments of the stakeholder community, other areas of agreement could be noted. The following is a brief summary of those perspectives.<sup>20</sup>

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<sup>18</sup> International Post Corporation, Market Flash, Issue 224, February 2002.

<sup>19</sup> See Appendix I, *Overview of the Universal Postal Union*, for more information.

<sup>20</sup> See Appendix J, *Stakeholder Outreach: Process and Results*, for more information.

## Consumers

By and large, consumers expressed a high degree of overall satisfaction with the Postal Service. While it could be marginally more efficient, overall they stated that they like the service they receive. However, when told that greater financial pressures would be confronting the Postal Service, they expressed a willingness to entertain such initiatives as changes to the laws that govern the Postal Service, modifications to the universal service mandate, and modifications to service levels.

## Postal Employees

A number of individual employees, as well as organizations representing employees, chose to comment on the *Outline for Discussion*. A survey of Postal Service executives was conducted on the topic of the strategic transformation of the Postal Service, and efforts were made to solicit the views of mid-level managers and Advanced Leadership Program enrollees and graduates. Additionally, the Postal Service Board of Governors facilitated a panel session with the presidents of unions and management associations to collect first-hand input from these stakeholder groups.

Employees generally agreed that universal service must be preserved; that transformational changes should be made quickly; that strategic initiatives should be introduced to promote growth; and that flexibility should be created to allow the organization to become more competitive.

## Mailers and the Mailing Industry

Mailers have been engaged in an ongoing discussion with the Postal Service regarding transformation. Additionally, many mailers provided written comments to the *Outline for Discussion*. Small business customers were also included in focus groups and surveys. The Postal Service Board of Governors facilitated a panel session with six mailers to discuss transformation. The findings of the Mailing Industry Task Force, presented at the October 2001 National Postal Forum, were also reviewed as part of the input assessment process.

As a whole, the mailing community acknowledged the need for transformation and felt that the Postal Service should: 1) not underestimate the seriousness of the problem, 2) be bold and explicit in its recommendations, 3) move quickly to implement proposed initiatives which would not require legislative action, 4) hold the line on large and frequent rate increases 5) pursue cost-cutting measures, and 6) strive to increase productivity. Several said that the universal service mandate should be reviewed and modified. Others said the *Outline for Discussion* failed to convey a sense of urgency. Many of the mailers recommended that a presidential commission be established to respond to the long-term problems of the Postal Service. Others urged that the Postal Service work to raise its debt ceiling and to address the issue of its unfunded liabilities.

## Suppliers

While some suppliers commented on the *Outline for Discussion*, the main outlet for supplier feedback has been meetings with suppliers and the Supplier Quality Council. The purpose of the Supplier Quality Council is to provide a forum for suppliers to dialogue with the Postal Service to enhance performance and operations.

A unanimous opinion voiced by suppliers was for the Postal Service to recognize the need for transformation and for it to act quickly. Suppliers also were concerned about the reductions in capital spending on supply chain improvements. The main topic of discussion at these meetings was the strategic direction of the Postal Service. Specifically, suppliers were concerned about buyer/supplier alignment and making it easier for the Postal Service to do business with its suppliers.

### **Public Policy Community**

The public policy community, which includes independent policy institutes and other independent observers, has addressed the subject of transformation in papers, articles, testimony, books and other discussion documents issued since the Postal Service was called upon last spring to develop a transformation plan. In Appendix J, *Stakeholder Outreach: Process and Results*, an annotated bibliography includes some of the publications that were considered in the planning process. There were no overarching trends in the comments the policy community offered other than that the Postal Service is facing major challenges and must make substantial changes to respond.

### **An Ongoing Process**

The process of collecting stakeholder input on postal transformation and, with this publication, the *Transformation Plan*, will continue. The objectives and strategies described in the *Plan* will be integrated into the annual strategic planning process, and refined through additional analysis and review. As part of that process, stakeholder input will be solicited, assessed and incorporated. A variety of channels and approaches will be used to ensure ease of access for any interested stakeholder.