

JOHN E. POTTER
POSTMASTER GENERAL, CEO



October 1, 2001

Honorable Joseph I. Lieberman
Chairman
Committee on Governmental Affairs
United States Senate
Washington, DC 20510-6250

Dear Mr. Chairman:

Enclosed is a document that takes the first step in developing the Comprehensive Transformation Plan for the future of the U.S. Postal Service that you requested in your letter to me of June 14.

We appreciate the opportunity that you and your colleagues have provided management and the Governors of the Postal Service to outline a Transformation Plan to address the challenges of serving the American people in the 21st century.

As you have requested, the Plan will be completed and submitted to you by year's end. As an interim step, to encourage the participation of postal stakeholders, the Postal Service is issuing this paper entitled, "*Outline for Discussion: Concepts for Postal Transformation.*"

The *Outline* reviews the need for postal transformation and describes the framework that the Postal Service is using to prepare the Plan and to compare the pros and cons of various options. The *Outline* includes a summary of the challenges and the opportunities for change. We hope that this *Outline* can provide a starting point for both the experienced postal observer and the citizen who is concerned with the future of this institution to enter into a discussion about our transformation.

Please let me know if you would like to get together to discuss the *Outline* or any other postal issues.

Sincerely,


John E. Potter

OUTLINE FOR DISCUSSION: CONCEPTS FOR POSTAL TRANSFORMATION

Submitted by the United States Postal Service
September 30, 2001

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Executive Summary

The United States Postal Service is one of America's most enduring institutions, an enormous communications network designed to "bind the nation together through the personal, educational, literary, and business correspondence of its people."¹ An independent entity of the federal government, it is directed by law to provide universal postal communications to all persons residing in the United States. It was established before the American Revolution and has functioned without interruption for 226 years. Today, with annual revenues approaching \$68 billion, it is the eighth largest organization in the country, and, if included, would rank as the twenty-sixth largest enterprise on *Fortune* magazine's Global 500. It has a career workforce of nearly 800,000, which makes it one of the largest employers in the nation, and its diverse products and services anchor an \$871 billion mailing industry, which in turn employs nearly 9 million Americans.

However, today's soft economy, changing global markets, new technologies, and the need to deliver mail to an ever-increasing number of addresses are combining to put the future of the Postal Service at risk. The Congress and the General Accounting Office have taken note of this and asked the Postal Service to produce a Comprehensive Transformation Plan by the end of the year that will address how the Postal Service proposes to meet these challenges. This document, *Outline for Discussion: Concepts for Postal Transformation*, is a progress report on the Postal Service's first steps toward transformation and an open invitation to stakeholders to join the discussion. The Postal Service is reaching out to the American public and policy makers and asking them to consider how the Postal Service can best serve them and the American economy in the 21st century.

The Postal Environment

While much of the previous decade was marked by financial success for the Postal Service, significant marketplace shifts – emerging alternative communications technologies, new competitors both domestic and international, and changing consumer attitudes and behaviors – have altered the landscape. Within the next decade technological innovations such as mobile commerce, broadband Internet access, interactive TV, data mining software, and new printing technologies will change the way businesses and consumers interact. Domestic delivery firms, such as United Parcel Service (UPS) and FedEx, and liberalized foreign posts, such as Deutsche Post World Net and TPG of the Netherlands, are aggressively competing in Postal Service markets. These drivers for change are moving rapidly and will continue to change the traditional postal business whether or not the Postal Service transforms.

Meanwhile, although the six major markets in which the Postal Service operates – retail, financial services, communications, advertising, logistics and delivery services – are expected to grow, the long-term role of the Postal Service in those markets is uncertain. Electronic billing and payments, pre-

¹ Title 39, U.S. Code, Sec. 101 (a).

authorized debits to bank accounts and credit cards, and Internet-enabled Electronic Data Interchange will reduce the need for and use of paper bills and payments. Electronic communications will grow at a much more rapid pace than traditional hard-copy communications, particularly on the Internet. Using modern technology, advertising will be more targeted, personalized, and interactive. The logistics and delivery markets will use increasingly sophisticated information systems to provide integrated, supply chain management solutions to customers' needs. Global liberalized posts are acquiring logistics companies and other mail-related businesses both in and outside of the United States to position themselves as communications and logistics global conglomerates. The United States Postal Service, operating under current law, has not joined them.

Challenges

The current legal framework is but one of several challenges that has led the Postal Service and its stakeholders to seek change. Future challenges to success exist within postal operations, in the structure of postal finances, and in the necessity to find, train, and equip the workforce and its future leaders. Each of these areas requires attention in any discussion of the future. Among the specific issues to address is that possible reduced mail volume, when combined with cost increases for labor, employee health care and retirement costs, fuel, and facilities will drive a continuing gap between revenue and expense with severe financial implications for the Postal Service.

As the Postal Service nears its statutory \$15 billion debt ceiling, it faces a critical challenge in terms of cash flow and capital investments. Capital investments have reduced costs through mail processing automation, but future productivity gains may be harder to find. Technology investments, likewise, are necessary to transform service offerings and prices to meet future customer requirements. The break-even requirement of the Postal Service and the uncertainty of the future economy will also make these investment needs difficult to fulfill.

Controlling the costs associated with the universal service obligation is another challenge. A transformed Postal Service must consider alternative methods of reducing these costs and providing universal service as mail volume growth declines and the delivery network expands. Network improvements will be considered in the Transformation Plan to reduce these costs. Challenges in the human capital arena include workforce planning and complement adjustments within the constraints of current labor agreements. Today's binding arbitration processes eliminate the threat of labor stoppage, but many believe that these processes could be improved. Postal Service compensation must also be reviewed, since today's salary caps drive some potential leaders as well as skilled, experienced executives to other organizations.

Taken together, these internal and external issues form a series of challenges that the Postal Service, as currently structured and regulated, must address. If a private corporation faced these same challenges, it might close facilities, reduce output or services, sell assets, abandon some unprofitable ventures, merge with another company, or even close its doors. These are not options for the Postal

Service. It must continue to operate to fulfill its obligation to the nation. How it will do so and in what structure are the challenges of transformation.

Transformation Strategies

The *Outline for Discussion* proposes three phases of organizational transformation for consideration and, within each phase, discusses several strategies. The three parallel phases to be considered are:

- Incremental administrative and operational improvements possible under current law;
- Moderate legislative reforms; and,
- Fundamental structural transformation.

Current Postal Service actions to freeze capital expenditures, reduce the number of managerial employees, and take costs out of operations are examples of incremental administrative and operational transformation, and fall within the legal and public policy framework that exists today. Through administrative and operational action that is permitted under the current law, the Postal Service would continue to use existing authorities to reduce costs, increase efficiency and generate new revenues. The model for this phase is continuous improvement of the current Postal Service.

The objective of moderate legislative reform would be to improve the flexibility of the Postal Service and prepare it for the future. Key reforms could include more flexible pricing, allowing the Postal Service to make a profit, adoption of network improvements, and compensation changes. The options for legislative reform range from modest reforms that would enable streamlined rate-setting processes, to reforms that would grant the Postal Service greater commercial freedom. One aspect of this change might be structural separation between monopoly services and competitive services, a topic discussed for several years during debate over legislative reform.

Fundamental structural transformation would reconstruct the basic postal model based on a redefinition of a universal service obligation. This phase could entail transformation into a for-profit corporate enterprise, owned either by the government, Postal Service employees, or the public through an offering of stock. Still other fundamental structural reform models may be suggested by stakeholders in coming weeks. All would seek to achieve fundamental reform of the factors that contribute to postal costs and revenues and the basic business model of the Postal Service that has existed since 1970.

Stakeholder Input and Next Steps

A Steering Committee of senior executives selected by the Postmaster General will formulate the Transformation Plan. The Postal Service will coordinate stakeholder input and internal analysis of the transformation phases. Subject matter experts and specialists throughout the enterprise will develop strategies and analyze the impact of proposed changes. Specialists from other government agencies and the private sector will also be asked to focus on and address Postal Service transformation issues.

To obtain stakeholder participation in the development of the Transformation Plan, the Postal Service has developed a two-step stakeholder engagement plan. Step One was designed to provide background for this *Outline for Discussion* and entailed a dozen informal meetings in August and September 2001. Postal Service executives and representatives of postal policy makers, unions, management associations, the Postal Rate Commission, major mailers, and postal trade associations participated. Outreach during Step Two will include publication of the *Outline for Discussion* on the Postal Service's Strategic Direction web site at www.usps.com/strategicdirection. In addition, a special notice will be placed in the *Federal Register*, directing interested parties to the web site for their comments. Focus groups of small business owners and consumers will be convened, and postal employees will be reached through internal communications. Additional meetings will be conducted with representatives of postal unions, management associations, the Postal Rate Commission, major mailers, suppliers, competitors, critics and others. A summary and analysis of stakeholder comments will be incorporated in the Comprehensive Transformation Plan to be submitted at year end.

This *Outline for Discussion* is a "living document," the first step in a complex, ongoing process. The collected input, analysis, and conclusions will assist policy makers as they guide the future of the United States Postal Service. The basic questions that are raised in this document are:

- To best serve the needs of the American people and the American economy in the 21st century, what should America's postal system be like (or transform to) in the next decade?
- Should that postal system provide universal service and what should that entail?
- What should the "core" services of the future postal service be?
- How should the nation structure a future postal system to be as productive and efficient as possible and to ensure that consumers pay only what they wish to pay, for as much service as they can afford?
- Can the Postal Service continue to provide universal service under the current financial arrangements if volume slows or declines significantly? Are there other financing mechanisms needed?
- What steps should be taken today to anticipate the human capital requirements of the future postal system in a manner that embodies core values of respect, dignity and diversity while providing incentives to encourage continuous service improvement?
- Is it possible to design a government postal system in the United States that operates more commercially and still serves important social objectives including universal coverage?
- How would a privately owned postal entity or entities perform against public expectations for postal services? Are there other models that may do a better job for the American people?

Informal discussions with stakeholders and policy makers have reconfirmed that there is a lack of policy consensus about the answers to these questions and others. There may not be a need for all stakeholders to agree on every question. But it is expected that there may need to be a process of public policy discussion before issues can be resolved and a widely accepted transformation plan can be crafted. The purpose of this *Outline for Discussion* is to facilitate that process.

Preface

In 1995 the Postmaster General of the United States called for legislative reform. That same year the House of Representatives Subcommittee on the Postal Service began an intensive review of the law under which the Postal Service has operated since 1971 and determined that current law would no longer suit the needs of the nation in the 21st century. In the ensuing six years, efforts in the House to modernize postal law have provided ongoing opportunities for the postal community to address, discuss, and analyze proposals about the future of the Postal Service. These efforts are continuing.

In March of 2001 the Postal Service Board of Governors wrote the President and Congress asking for a comprehensive review of postal laws.² In April of 2001, in testimony before the House Government Reform Committee, the Comptroller General of the United States placed Postal Service transformational efforts on the General Accounting Office's (GAO) high-risk watch list.³ The Committee asked the Postal Service for its recommendations, and the Postal Service Board of Governors responded, writing to the House and Senate oversight committees that "we believe that regulatory reform is needed for the preservation of universal service."⁴ The Senate also asked the Postal Service for its recommendations and, on June 14, 2001, the chairmen and ranking members of the Senate oversight committee and subcommittees⁵ wrote to the Postmaster General requesting that a Comprehensive Transformation Plan be completed by the end of the year.

The Comprehensive Transformation Plan will be submitted to Congress at the end of the year. Congress has urged the Postal Service to develop this plan in partnership with its stakeholders. This *Outline for Discussion: Concepts for Postal Transformation* is an interim report. This paper tells the Postal Service's story to explain why transformation is needed and to provide a context for discussing alternative choices for taking action. Many readers may be familiar with this detail and some may wish to turn to Section 6. The report is designed to generate discussion among all postal stakeholders to address the fundamental question: "*To best service the needs of the American people and the American economy in the 21st century, what should America's postal system be like (or transform to) in the next decade?*"

² The Board of Governors March 2, 2001 letters to the President of the United States and to Congress. (Appendix A.)

³ *U.S. Postal Service: Transformation Challenges Present Significant Risks* (GAO-01-598T) Testimony of Comptroller General David Walker before the Committee on Government Reform House of Representatives, April 4, 2001. (Appendix A.)

⁴ The Board of Governor's May 15, 2001 letter to the oversight committees. (Appendix A.)

⁵ The June 14, 2001 letter sent to Postmaster General John E. Potter from Senators Joseph I. Lieberman, Chairman, Senate Committee on Governmental Affairs; Fred Thompson, ranking member; Daniel K. Akaka, Chairman of the Subcommittee on International Security and Proliferation and Government Services, and Thad Cochran, ranking member of the Subcommittee. (Appendix A.) Mr. Potter's June 25, 2001 response is also included in Appendix A.

Section 1: Introduction

The United States Postal Service: Why Transform?

The United States Postal Service is one of America's most enduring institutions, an enormous communications network designed to "bind the nation together through the personal, educational, literary, and business correspondence of its people."⁶ A self-sufficient, independent entity of the federal government, it is directed by law to provide universal postal communications to all persons residing in the United States. It was established before the American Revolution and has functioned without interruption for 226 years. Today, with annual revenues approaching \$68 billion, it is the eighth largest organization in the country. If included, it would rank as the twenty-sixth largest enterprise on *Fortune* magazine's Global 500. With nearly 800,000 career employees, the Postal Service is one of the largest employers in the United States. In addition, its diverse products and services anchor an \$871 billion mailing industry, which in turn employs nearly 9 million Americans and represents approximately 9 percent of the nation's Gross Domestic Product.⁷

Daily, more than 250,000 Postal Service letter carriers deliver to the nation's 135 million addresses, while the Postal Service's 38,000 post offices, stations and branches provide more retail outlets than McDonald's and ExxonMobil combined.⁸ In 2000 the Postal Service carried 46 percent of the world's mail, delivering more than 207 billion pieces, and added 1.7 million new delivery points nationwide, a number equivalent to a city about the size of Chicago. In roughly one week Postal Service mail volume matches the annual volume of United Parcel Service, and in two days the Postal Service delivers what FedEx delivers in a year.

Record mail volume, record service points and record revenue should assure financial stability for the Postal Service, but today's soft economy, changing global markets, new technologies, and the ever-increasing number of addresses challenge that future. The Postal Service faces aggressive competition from both domestic and foreign sources.⁹ Its letter mail services are increasingly vulnerable to substitution from new technologies, for example, phone-based and online bill payment.¹⁰ Competition, electronic substitution and the weak economic outlook put the Postal Service's existing revenue stream at risk. Meanwhile, investments required to expand and improve the postal delivery network are resulting in growing organizational debt, and the Postal Service could exhaust its statutory \$15 billion borrowing limit by the end of fiscal year 2003. As a result of these

⁶ Title 39, U.S. Code, Sec. 101 (a).

⁷ Data developed for the *Mailing Industry Taskforce Report* by the United States Postal Service Market Intelligence and Segmentation Group, 2001 (Breakout of estimate found in Appendix B.)

⁸ Data taken from McDonald's 2000 *Annual Report* and ExxonMobil 2000 *Annual Report*.

⁹ There are approximately twelve postal administrations that compete directly with the Postal Service. Some of these posts, e.g., the United Kingdom's Consignia, Deutsche Post World Net, Canada Post Corporation, and TNT Post Group of the Netherlands, have a physical presence in the United States. Deutsche Post World Net's recent acquisition of DHL, the Postal Service's strategic alliance partner in the Postal Service's Global Express Guaranteed mail product, is an illustration of the competition facing the United States Postal Service.

¹⁰ Approximately one-quarter of Postal Service revenue comes from the delivery of bills, statements, and payments.

marketplace and business realities, the Postal Service confronts the prospect of steady and ever-widening losses.

If a private corporation faced these same challenges, it would reconsider its product offerings and adjust its infrastructure to better balance customers' needs with price elasticities. Actions such as reducing the number of retail outlets, adjusting service standards, and matching frequency of delivery to volume to be delivered would be taken. Not all of these options are available to the Postal Service. Some stakeholders believe that to maintain its financial viability the Postal Service will need to consider politically unpalatable options.

At issue is whether the Postal Service, an asset held in common for the citizens of the United States, can continue to provide the affordable, ubiquitous and secure mail service on which the nation depends. Whether for personal or commercial communications or for building community or enabling commerce, mail today remains vital to the nation's daily life and economic health. For example, more than \$1 trillion in financial transactions move through the mail every year.

Whether the Postal Service can, under the current financial and regulatory model, continue as a self-sustaining service organization is at issue. Congress, the Government Accounting Office (GAO), and the mailing community are raising critical public policy questions about how relevant the Postal Service will remain if current trends continue. With this document, the Postal Service seeks to promote a public process of deliberation. This process will enable Americans to focus on the critical issues confronting the Postal Service, gain the insights of experts and of diverse interested parties, contribute to a national discussion of the issues, and ultimately through the actions of its representatives decide the future of the Postal Service.

Transformation Approach and Key Issues

At year-end, the Postal Service will deliver a Transformation Plan to Congress and to the President. To develop this plan, the Postal Service will consider the following key issues 1) the current and future mission of the Postal Service; 2) legislative and administrative reforms necessary to address the underlying structural barriers that affect the ability of the Postal Service to fulfill its mission; and, 3) the human capital, operational and financial implications of these reforms. What is clear is that inaction on these issues is not an option. As the Comptroller General testified:

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.¹¹

¹¹ *U.S. Postal Service: Transformation Challenges Present Significant Risks*, Statement by David M. Walker, Comptroller General of the United States, testimony before the Committee on Government Reform, House of Representatives, April 4, 2001, p 18. (Appendix A.)

This *Outline for Discussion* describes three transformational phases. The three phases suggest a path toward a more commercial, competitive Postal Service. They are 1) incremental but aggressive administrative and operational improvements without legislative change; 2) moderate legislative reform providing some additional flexibility; and, 3) fundamental structural transformation. Within the three phases are a range of options: from focusing on investments in revenue growth and increased efficiency under the current model, to a “corporatized” enterprise within a competitive market.¹² The three phases will be analyzed as parallel phases, allowing the Postal Service to highlight the actions that should be taken today to prepare for the Postal Service of the future.

During October 2001, the Postal Service will further engage the public through additional meetings with postal policy makers, mailers, representatives of labor and employee groups, the Postal Rate Commission, small businessmen and citizens, asking them for feedback. Opportunities for formal public review will be provided, and comments on the impact and importance of the three phases will be solicited.

Questions for Public Comment

In considering these major challenges and the financial, operational and human capital implications of each, a key question is how the Postal Service should transform to prepare for the business environment it will face in the future. This question will be considered as the Transformation Plan is developed and product improvements, network optimization, workforce planning, financial and administrative restructuring and other strategies for each phase are examined.

The *Outline for Discussion*, background material and a series of related questions may be found on the Postal Service’s Strategic Direction web site at www.usps.com/strategicdirection or at www.usps.com keyword: transformation. Printed copies can be obtained by calling 202-268-6005. Comments should be emailed to: transformation@email.usps.gov, or mailed to Julie S. Moore, Executive Director, Office of Transformation, Strategic Planning, Room 4011, U.S. Postal Service Headquarters, 475 L’Enfant Plaza, SW, Washington, DC 20260-1520. Comments must be received by November 1, 2001.

¹² In order to generate discussion around future visions, five scenarios within the three transformational phases were shared in preliminary, informal meetings with representatives of 12 groups identified in Section 7: Stakeholder Input. Appendix C includes an overview of these five scenarios.

Section 2: The Current State of the United States Postal Service

The History and Structure of the United States Postal Service

When the Continental Congress named Benjamin Franklin the first Postmaster General in 1775, the United States was a weak confederation of colonies scattered along the eastern seaboard. The postal system created by the Congress helped bind the new and expanding nation together, supported the growth of commerce, and ensured a free flow of ideas and information.

For nearly 200 years the federal government ran the postal system under close political supervision. Postmasters General, dating back to Andrew Jackson's administration in 1829, were members of the Cabinet. As the nation expanded westward, the Post Office Department expanded as well. Operating on the forefront of technological innovation, the Post Office Department was first in the commercial use of railroads, automobiles, and airplanes in its quest to expedite the delivery of correspondence across a growing nation and to create the necessary vast communications infrastructure to support that delivery.

By the mid-1960s, however, the Post Office Department was in trouble. Years of financial neglect and fragmented control had impaired its ability to provide modern facilities, equipment, wages, and management efficiency. In addition, heavily subsidized postage rates for all classes of mail bore little relation to costs.

After service failures in Chicago in 1966, and ensuing labor unrest, Congress approved and President Richard M. Nixon signed into law the Postal Reorganization Act of 1970. The new law restructured the postal system into an "independent establishment of the executive branch."¹³ To run the postal system the legislation created an 11-member Board of Governors, including 9 Presidential appointees plus the Postmaster General and Deputy Postmaster General. The new United States Postal Service was intended to insulate postal operations from politics, ensure greater management authority for the Postmaster General, and create a collective bargaining structure with binding arbitration to banish potentially crippling strikes. In addition, the new Postal Service, which began operations in 1971, was to be self-supporting with a break-even financial mandate.

The 1970 law preserved the historic public mission of the Postal Service to maintain universal service for every United States address. To help protect the financial base necessary to perform this mission, the law also preserved traditional monopoly protections for letter mail and reserved access to the mailbox. As a government organization with a statutory monopoly, the Postal Service is highly regulated. The 1970 legislation created an independent Postal Rate Commission, which holds lengthy and public administrative hearings before rates and mail classifications can be changed. The Postal Service is also subject to extensive government review through several congressional

¹³ Title 39, U.S. Code, Sec 201.

oversight bodies, the General Accounting Office and, since 1996, the Office of the Inspector General, which is independent of postal management.

The Mission of the United States Postal Service

When the Postal Reorganization Act became law in 1970, two sections, one on postal policy and the other on general duties, spoke most directly to the “mission” of the newly created United States Postal Service. The overall mission established by the law was:

to provide postal services to bind the Nation together through the personal, educational, literary, and business correspondence of the people, and to provide prompt, reliable, and efficient services to patrons in all areas¹⁴

Among the general duties of the new entity were to:

provide adequate and efficient postal services at fair and reasonable rates and fees, and ...receive, transmit, and deliver throughout the United States, its territories and possessions, and, throughout the world, written and printed matter, parcels, and like materials and provide such other services incidental thereto as it finds appropriate to its functions and in the public interest.¹⁵

These policy and operational directives codified the historical mission of the American post. Many stakeholders have expressed their views that the universal service mission of the Postal Service might need to be further defined to meet the future market environment.

The Universal Service Mission

The Postal Service mission forms the basis of what is sometimes thought of as the Postal Service’s universal service obligation, popularly described as mail service to “Everyone, Everywhere, Every Day.” The universal service mission, in turn, with other social obligations, has been part of the justification for the Postal Service monopoly, codified as the Private Express Statutes and other authorities related to delivery. The Private Express Statutes grant the Postal Service the exclusive right, with certain limited exceptions, to carry letters for compensation.¹⁶ Another statute prohibits any person from placing material into a mailbox.¹⁷ These statutes were adopted to ensure the Postal Service a revenue base sufficient to provide universal service. In other words, the Private Express Statutes seek to assure enough

In the future, how shall universal service be defined?

¹⁴ Title 39, U.S. Code, Sec. 101 (a).

¹⁵ Title 39, U.S. Code, Sec. 403 (a).

¹⁶ Title 18, U.S. Code, Sec. 1693-1699; Title 39, U.S. Code, Sec 601-606.

¹⁷ Title 18, U.S. Code, Sec. 1725.

revenue so that the Postal Service can serve all communities, large and small, even in places where the service does not pay for itself.

Universal service today encompasses a wide array of products, a uniform price for letters sealed against inspection, six-day-a-week, nationwide delivery, and nationwide access to an extensive postal retail network. Universal service also includes affordable, fair and equitable prices for all citizens and all mailers. According to some economists, any universal service obligation, regardless of industry, must address 1) the scope and manner of service (frequency and speed of delivery); 2) access; 3) affordability; 4) array of products; and, 5) the security of the transmission.¹⁸ In recent years various postal experts have suggested that the above five universal service elements could be met with non-traditional means and that the Postal Service could still fulfill its mission requirement to “bind the nation together.” A number of stakeholders have agreed and recommended that postal universal service be specifically defined and its cost analyzed and distinguished from commercially viable services. However, in foreign posts and in other industry sectors such as telecom, aviation, and utilities, determining the cost of universal service as a distinctive component from profitable operations has proven difficult and highly contentious.

The Monopoly and Regulation

Public policy today generally demands that grants of monopolies, necessary in certain instances to ensure a universal service mission, be accompanied by some form of regulation to protect the public interest. Regulation varies markedly by country and industry, and its object is to assure that the protected enterprise performs reasonably, fairly, and at affordable costs. In the current postal structure, the Governors and the independent Postal Rate Commission, a total of 14 Presidential appointees, have the primary responsibility for determining postal rates, classifications, and new services. In a major rate case, the Governors request some 4,000 rates that it has determined meet 9 statutory rate-setting criteria, including a fair and equitable rate schedule, the value of mail to sender and recipient, and the educational, cultural, scientific, and informational value of the mail to recipients.¹⁹ As long as a universal service mission and some form of monopoly protection apply, most stakeholders believe that Congress is likely to impose some form of regulation. What regulatory improvements might be more suitable for the future will need to be addressed, along with stakeholder suggestions and policy maker involvement in defining the issues of mission and universal service.

¹⁸ Security of the United States mail is the purview of the Postal Inspection Service, a Federal law enforcement agency with jurisdiction in criminal matters affecting the mail. It provides assurance to American businesses for the safe exchange of funds and securities through the U.S. Mail; to postal customers of the "sanctity of the seal" in transmitting correspondence and messages; and to postal employees of a safe work environment.

¹⁹ Title 39, U.S. Code, Sec. 3622.

The underlying drivers for universal service are market demand and consumer and industry expectations. These expectations may change as behaviors, technologies, and competitive responses evolve.

The Current Postal Service Market

The Domestic Picture

Since the 1970 Postal Reorganization Act, mail volume in the United States has increased nearly 80 percent per capita²⁰, and overall has grown 139 percent. Delivery points have increased by 69 percent, while efficiencies have kept the growth in postal employment to only 24 percent. Many new products, alternatives, and discounts have been offered to postal customers. Among government agencies, the Postal Service has been recognized as a leader in many areas of technology and financial planning.²¹ While remaining a government organization, the Postal Service has, until recently, been one of the world's more liberalized and forward-looking posts. What was not foreseen in 1970 was today's ongoing technological revolution, with an impact on hard-copy delivery that remains to be fully assessed and understood.

The Mailing Industry

The Postal Service, as noted, is a major presence in the market. The Postal Service purchases or leases billions of dollars worth of facilities, vehicles, equipment, and supplies every year. Postal employees purchase uniforms, services and other items associated with their work. Much of the revenue earned by the Postal Service returns to the economy quickly and directly. The rest returns indirectly through the salaries and benefits of postal employees, who represent significant consumer buying power in their communities.

The Postal Service and its competitors represent only \$206 billion of the \$871 billion mailing industry. Many of the companies in the mailing industry were created in response to postal policies of outsourcing and providing "worksharing" discounts to mailers for performing work that the Postal Service would otherwise do. Today the mailing industry is diverse, ranging from giant printing establishments to graphic arts enterprises. Many of the players are direct intermediaries between the Postal Service and the owners of the mail, while others are services, often separate subsidiaries or contract services, that run large mail production plants or payment processing centers. This industry, representing businesses that provide direct and indirect mailing services – the technology, the

²⁰ *Postal Technology International*, June 2001, p 20.

²¹ *Government Executive*, April 2001 Special Issue: Grading Government, pp 55-64.

infrastructure, the access and the preparation of mail pieces themselves for the network – generates approximately \$430 billion in revenues in the United States and employs about 6.3 million people.²²

Mail Intensive Industries

While virtually every establishment in the United States sends or receives mail, most mail volume is generated directly or through mailing industry intermediaries. For these industries, mail is an integral part of their business processes. These segments include mail order companies, for which the Postal Service delivers the majority of packages between businesses and consumers. Mail order companies use a variety of delivery services and communication media, but they still rely on the mail, especially for delivery of their catalogs.²³ The domestic mail order industry generates approximately \$111 billion in sales and employs about 300,000 people.²⁴

Other major players are the publishing and printing industries. One of the specific purposes of the postal system is to ensure national reach for magazines, newsletters, and newspapers. This function has been deemed essential enough by Congress to warrant continued special attention and treatment in the mail system through reduced rates on editorial content. Although most newspapers are delivered locally through non-postal networks, many publishers still depend on the postal system to deliver non-local copies to subscribers who keep in touch with their former home communities. Publishers of smaller non-daily newspapers are more dependent upon the mail system, despite the availability of electronic distribution and non-postal delivery alternatives.

Publishing generates approximately \$100 billion in domestic sales and employs about 900,000 people. Adding in printers associated with greeting cards, documents, forms, labels, and other items that eventually go into the mail, the total rises to about \$124 billion in revenue.²⁵

The direct mail production process, including creative services, graphic arts, list management, fulfillment and other services, also contributes to the economy at the retail level in terms of revenues and employment.

The Larger Market

The Postal Service and the mailing industry exist within a larger market for communications services. These include other advertising services (non-direct marketing), telephone and electronic messaging services, and associated industries. The communications firms, in addition to being large customers of the Postal Service and the mailing industry, are also indirect competitors. Changes in

²² Data developed for the *Mailing Industry Taskforce Report* by the United States Postal Service Market Intelligence and Segmentation Group, 2001. (Breakout of estimate found in Appendix B.)

²³ *Forecasting the Consumer Direct Channel: Business Models for Success*, Peppers and Rogers Group and the Institute for the Future, 2000.

²⁴ Data developed for the *Mailing Industry Taskforce Report* by the United States Postal Service Market Intelligence and Segmentation Group, 2001 (Breakout of estimate found in Appendix B.)

²⁵ *Ibid.*

the structure of the Postal Service, the mailing industry, and postal markets will also affect these firms. These firms account for about \$725 billion in sales and employ about 2.2 million workers.²⁶

The Global Picture: The International Mail Market Today

The international mail market today includes global delivery services for letters, printed matter such as advertising mail and catalogues, standard packages, and expedited shipments that weigh less than 70 pounds. The market revenue for export delivery services from the United States is \$6.25 billion, with the standard parcels expedited shipment segments comprising more than 80 percent of this global opportunity. The market revenue for import delivery services to the United States is approximately \$4 billion.

The United States Postal Service currently has a dominant position in the traditional letters and printed matter segments that comprise the remaining 20 percent of the market. However, these segments are stagnant, with little growth forecasted for the future as technology offers customers faster, electronic solutions to deliver their messages in a global market place. Additional competition in these segments comes from foreign postal administrations, which have established a sales presence in the United States since 1986, when monopoly protection for outbound international mail was eliminated.

The market segments for standard parcels and expedited shipments have grown dramatically in the past 15 years, although this annual growth has slowed to less than 10 percent in recent years. Annual growth on a global scale is forecasted at 5 percent for the next several years, with some geographic regions, such as Asia-Pacific, forecasted for faster growth. Global integrators such as FedEx, UPS, and DHL are the dominant service providers in these segments, comprising about 93 percent of the American market.

In recent years a number of industrialized countries have commercialized their Posts, among them Deutsche Post, TPG of the Netherlands, Consignia of Great Britain, La Poste of France, New Zealand and Australia Post. Ad J. Scheepbouwer, CEO of the Netherlands' post, TPG, predicted that "In the future there will be just four Super Posts, and the sleeping giant of the United States Postal Service will not be one of them."²⁷ Despite Scheepbouwer's comments, the American people still have a say in how this prediction turns out.

²⁶ *Ibid.*

²⁷ *Global Competitive Update: "Playing the Hand Dealt in a High Stakes Environment,"* PricewaterhouseCoopers. January 2001: p 6. Document written for the United States Postal Service.

Section 3: Drivers for Change

The current market environment offers many challenges for the Postal Service and the mailing industry as a whole. While addressing these challenges, the industry must not lose sight of the need to fit into a future

environment that is being shaped by consumer behavior, technological changes and the increasing sophistication of both domestic and global competitors. The world is changing and will continue to change, whether or not the United States Postal Service changes with it.

What should the “core” services of the future Postal Service be?

Consumer Behavior

Changes to the postal markets will influence a large portion of the American economy. Directly or indirectly, the postal sector accounts for more than \$871 billion in sales and employs more than 9 million people in the United States. Trillions of dollars in payments are made through the mail annually. The Postal Service and its physical delivery competitors deliver billions of packages annually to businesses and households. The growth of consumer retail spending currently depends, in part, on the ability of the mail system to influence demand.

Within a decade about 60 percent of American households will be considered “new consumers,”²⁸ highly educated and affluent by historic standards. These consumers, representing all ages, genders, and ethnic groups, will be extremely information intensive and will use all media, with the possible exception of television, more intensively. They will exercise more control over the media and messaging presented to them and will expect more flexibility and responsiveness from the channels and from content providers. The new consumers will be highly mobile and will pay attention only to relevant, carefully targeted messages or those from trusted and pre-approved sources. They will demand appropriate prices, quality, convenience, ease of use, and sufficient levels of choices or features.²⁹

At the same time, businesses will continue to depend on physical documents for communicating with customers, and publishers and printers will rely on a national marketplace for publications and printed material.

Technology

Within the next decade further technological innovations such as mobile commerce, broadband, interactive TV, data mining software, and new printing technologies will change the way businesses and consumers interact. The Internet and the World Wide Web have been and will

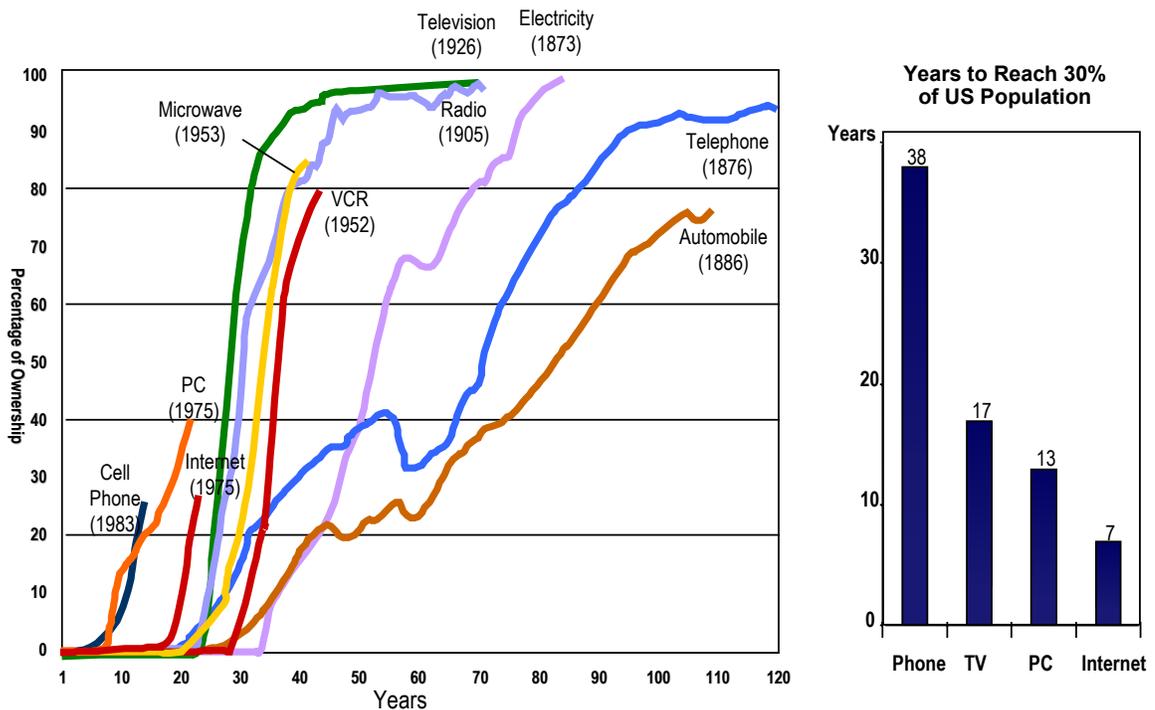
²⁸ 2010 Customers, Markets, and Opportunities Assessment, PricewaterhouseCoopers, 2001, p 7.

²⁹ 2010 Customers, Markets, and Opportunities Assessment, PricewaterhouseCoopers, 2001, pp 7-9.

continue to be drivers of technological change, with a majority of U.S. households having improved Internet access within the next few years. Traditional communications media, including postal services, have invested a great deal of energy and money in attempting to harness the Internet to improve speed, reduce costs, and increase the convenience of interaction with customers.

Parallel improvements in database management and computation have driven changes in data aggregation and analysis. Together, these drivers provide the platform for more changes in the future, especially as mobile communications technology becomes integrated with existing channels, and as security and access speeds continue to improve. What is particularly noteworthy about future technological change is the pace at which such change is occurring. It took 38 years for the telephone to reach 30 percent of the population; it took 17 years for television to reach the same number of people, and only 13 years for personal computers to establish the same market penetration. The Internet reached 30 percent of the population in just seven years. The following chart illustrates the pace of technology innovation and adoption of the automobile, telephone, electricity, radio, television, VCRs, microwave, PCs, Internet and cell phones.³⁰

Technology Adoption



Much of the discussion on the impact of technology on the mail and the Postal Service has been negative – that electronic communications will ultimately displace mail volume. There is no

³⁰ United States Postal Service, *The Household Diary Study, Mail Use and Attitudes in Postal Fiscal Year 2000*.

doubt that some traditional mail applications will be diverted. It is, however, possible that the new technology could create opportunities that might be compatible or complementary with traditional mail. Improvements in database management and printing technologies may also lead to improvements in the effectiveness and value of mail through greater customization and more rapid response. Both risks and opportunities need to be addressed when examining postal transformation.

Domestic Competition

The Postal Service today faces intense direct competition in many of its markets, particularly from firms such as UPS and FedEx. Such firms focus on the most profitable portions of the postal value chain, such as high-value documents and packages, delivered to businesses and high-density and high-volume neighborhoods. In some cases, these firms reduce service or increase rates for services to high cost deliveries. These firms are continuing to expand into other businesses, including an increasing portion of the postal value chain. 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.

Smaller, alternative delivery competitors, such as WebVan, NetGrocer, and Kozmo, were not able to develop successful competitive delivery models, but there are other potential competitors that could enter the market. For example, the infrastructure of an alternative delivery system could be built on the foundations of existing retail newspaper and magazine distribution systems. There is a fragmented network already available, and consolidation could provide the necessary economies of scale and scope.

A third, more controversial and speculative form of potential future competition has also appeared in the mail value chain. Firms that are clearly competitors in other contexts have now made investments to enter into the “worksharing” portions of the value chain where the Postal Service has collaborated with mail industry suppliers and service providers. At this point it is difficult to know whether this evolving segment of the value chain is a source of future competition to the basic Postal Service business model or whether it will continue to be a unique public-private partnership that has been central to growing the mailing industry.

Global Trade and Competition

The global competitive landscape for Posts is changing irreversibly. The expansion of the European Union (EU) is providing the 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 administrations such as Deutsche Post are moving far beyond traditional postal services, entering both the logistics and financial services markets while taking advantage of electronic services. They have entered the United States

domestic market and intend to compete directly with the Postal Service for profitable segments of postal business. Although the EU Directive aimed at opening Europe's postal markets to competition is mired in controversy, there is continuing pressure for open markets through the EU by 2009.

This international competitive world is and will continue to be characterized by massive regulatory reforms, cross-border acquisitions, alliances, and highly targeted products and services. Although it delivers 46 percent of the world's mail, the United States Postal Service does not have the option under present law to aggressively establish a competitive presence in the global market. The Postal Service does have, however, unique value as a provider of secure mail services.

Section 4: The Future Postal World

The Mailing Industry

The pace of the changes described in the previous section will continue to vary across applications and customer segments. The Postal Service's six major market segments – retail, financial transactions, communications, advertising, logistics, and delivery services – are all undergoing rapid change. This section offers several perspectives on potential market change and invites comments from stakeholders to guide understanding of the future marketplace.

Billing and Payment Services (Financial Transactions)

The market for financial services will grow significantly during the next decade. Although checks will most likely continue to be a major payment mechanism well into the future, and although the nation will continue to require prompt and efficient hard copy billing and remittance processing systems based on checks, it is expected that the use of checks will continuously decline as a percentage share of the total billing and payments process. This change will be driven in large part by the substitution of various kinds of cards and other payment devices for cash and checks. Handheld personal devices will be connected to the Internet and routinely used for payment. The decline of check usage at retail outlets will reduce the volume-based productivity of traditional private sector check processors. This, in turn, will increase the pressure on businesses to eliminate check usage to avoid the increasing costs of handling paper checks. The Federal Reserve has already reported a decline in the use of checks, and federal government policy is to replace payment by check with electronic payments wherever possible for all government transactions.³¹ As with other future trends, the interaction of customer demand and suppliers of services will determine the speed and accuracy of these projections.

Account consolidation, especially due to the use of credit cards to pay multiple bills (earning airline miles or other discounts) will also affect traditional mailed-check volumes. Consolidation of accounts, and the associated consolidation of statements, will accelerate due to mergers of financial institutions.³² The Postal Service will be increasingly dependent upon a relatively few, large, financial service firms and their information system intermediaries. Many bills and statements will be transmitted electronically to a print site close to the final delivery location, bypassing much of the current processing and transportation system, but requiring close cooperation among the mailer, printer, and the Postal Service, especially in tracking the documents.

Finally, many financial institutions, manufacturers, retailers, government organizations and information service providers are attempting to replace mailed bills and statements altogether.

³¹ Phillips Business Information, *Item Processing Report*, May 20, 2001.

³² *2010 Financial Market Assessment*, PricewaterhouseCoopers, 2001, pp 22, 23.

Electronic Data Interchange (EDI) is a long-established business-to-business practice that is moving to the World Wide Web, and in the next decade many of the current barriers to ease-of-use and security will have been resolved, at least for business-to-business bills. Many enterprises are attempting to build consumer demand for electronic bill presentment as well. Chief among them is the banking industry, which sees its current online banking customers as a captive audience for new bill presentment and payment features.

According to the *Technographics Report* from Forrester, a technology research firm, the percentage of U.S. consumers who pay bills online has been increasing dramatically since the beginning of 1999. At the beginning of 2001, the adoption rate was between 2 percent and 7 percent. By the beginning of 2002 consumer online bill payment is expected to reach 12 percent.³³ There is growing acknowledgement within the industry that an increasing number of households will inevitably accept electronic rather than mailed bills.

Communications

The broadly defined communication market is expected to double during the next decade. Electronic communication will continue to grow at a much more rapid pace than traditional hard copy communications, as improvements are made in security and ease-of-use. However, mailed document volume will also likely continue to grow, based in part on the increasing ability of firms to develop customized, high quality documents and to have them delivered quickly with tracking and security throughout the production and delivery process.³⁴ The increased ease-of-use of desktop document production systems and the improvements in printer capability will also mean that additional volume will be generated, although some volume will go through the same distributed printing system used for the local production and delivery of statements.³⁵

Advertising

It is anticipated that the advertising market will grow significantly during the next decade, with a diminishing difference between advertising and other communications. Both will be carefully targeted and personalized. The same desktop document production, printing, and distributed delivery system that supports advances in financial statements and business communications will enable more flexible, relevant, and timely advertising messages to be delivered to individuals within households.³⁶ Many direct mail campaigns will be integrated with other media, and technology will create new applications for interactivity between mailed pieces and other communication channels.³⁷

³³ Kenneth Clemmer, *Bill Payment Goes Mainstream*, The Technographics Report, July 2001, p 4.

³⁴ *Intelligent Document Task Force Report*, 2001.

³⁵ *2010 Communications Market Assessment*, PricewaterhouseCoopers, 2001, p 27.

³⁶ *2010 Advertising Market Assessment*, PricewaterhouseCoopers, 2001, p 25.

³⁷ *2010 Advertising Market Assessment*, PricewaterhouseCoopers, 2001, pp 18-19.

Logistics

The delivery and logistics market will continue to change dramatically during the next decade, since many of the technological opportunities created by the Internet have already been incorporated into current trends. UPS, FedEx, and others have been setting the standards for the evolution of the package delivery and freight markets. Customers in the future will expect easily accessible information at all stages of the supply chain process, increasing simplification of traditional processes, and integrated solutions to customer problems, including fulfillment, financing, warehousing, and logistics services.

Most observers would probably agree that the Internet and the World Wide Web, combined with the increasing power and reduced prices of personal computers, have changed the way businesses and consumers behaved during the last decade. Yet at the beginning of the decade, few foresaw these changes. The shape and pace of change during the next decade remains equally unpredictable. Some analysts argue that the Internet is just another communication channel to which both other channels and customers will adjust. Others strongly suggest that the changes in business and customer behavior are more likely to be revolutionary, perhaps in ways that cannot now be predicted. Some argue that the electronic messaging that now accompanies parcel shipping has created new value that is as important as the package itself.

New transparency in the supply chain encourages the use of information technology to create new performance measurements and customer interconnection with suppliers. Optimization of networks and dynamic pricing are two examples of new ways of thinking about reconstituting delivery networks so that they are used more efficiently. Flexible delivery, payment services, and merchandise return services will be the distinguishing characteristics of successful firms in this market.

The unpredictability of the changing market, with the associated requirement for greater flexibility and improved responsiveness to customer needs, is at the heart of the postal transformation issue. The Postal Service must be able to continue to fulfill its mission of providing prompt, reliable universal service at reasonable rates in dynamic, competitive markets.

The Global Market

Demands of the Global Market

The rapid changes occurring in the domestic mail markets parallel equally rapid changes occurring in global mail markets. These changes, like domestic changes, are being driven by customers' needs. On a global scale customers are seeking to 1) drive costs out of the supply chain; 2) pay reasonable costs for universal delivery service; 3) receive the lowest possible prices, with assured service performance; 4) substitute electronic services for letter and printed matter business;

5) use hybrid letter mail; 6) use low cost re-mail offerings for international mail; 7) maximize electronic commerce; 8) use liberalized posts to provide logistics service; 9) share risk and rewards with logistics suppliers; and, 10) operate around the world.

Another set of forces also drives the global repositioning of postal and non-postal competitors. The differences between Posts and other carriers is declining as each expands its range of services to offer customers a full range of integrated, one-stop services, value added components, and the information infrastructure to control these offerings in complicated shipment scenarios. As Posts “go global,” they are acquiring a full range of logistics capabilities through acquisition. They are becoming global mail conglomerates and are entering into direct competition with other Posts and private service providers. Revenue and earnings are increasingly dependent on the ability of Posts to meet customers’ global needs.

These factors are also driving Posts to redefine their role. In order for Posts to survive without being subsidized and still earn a reasonable return on investment, they must convert their services to meet the needs of customers for global “mail” service. This, in turn, creates a need for access to capital and the freedom to invest or own other critical assets.

The Future of the Global Market

Globalization of the world’s economies will result in the future international mail market being driven by customers’ needs for global distribution of their letters, printed matter, and packages. Households will continue to send mail around the world and will look for the most cost-effective way to do it. Business customers will send mail globally and will seek to drive costs out of their supply chains. “Mail” will consist of much more than today’s letters, printed matter and parcels.

These consumer demands will drive many postal and private service providers to become global logistics providers. International logistics revenues are currently at about \$150 billion, with about half of the market derived from mail moving to or from the United States. That market is expected to grow at an annual rate of about 7 percent for the next 10 years. Postal operators and private service providers are expected to compete fiercely for shares of this market.

The future market will consist of business customers seeking a full range of integrated logistics services from their “core carriers.” Performance-based contracts will be used to drive service quality, reduce costs and increase overall control of the logistics process. Customers will seek to make partners of their logistics providers, thus sharing in both risks and rewards. It is expected that successful postal operators will be fully integrated with their customers’ global business processes.

There is also expected to be considerable consolidation in the industry, with a small number of reliable and highly skilled service providers able to meet all of customers’ needs. The surviving large-scale, full-service logistics organizations will dominate the global mail/logistics business. Deutsche Post World Net, which includes DHL and other logistics acquisitions, is moving quickly in

that direction. Other global integrators, such as FedEx and UPS, are also acquiring logistics partners to capture a future share of the global logistics market. Because the opportunity is so large, other service providers will likely emerge to compete, perhaps on a regional level, to provide logistical services on less than a global basis.

In sum, the future markets of the global mail and logistics industry will require policy makers to focus on a number of transformational issues. Key concerns that will need to be addressed include:

- Will the few players left in the market provide a competitive private marketplace in the United States?
- What will be the American public and private presence in this future global mail market?
- What effect will the presence of foreign governments and private companies being created from former national postal services have on competition and universal service in the United States?
- What impact will the new global “mail” market have on the more than 9 million American jobs associated with mail?
- How should the United States Postal Service be best positioned to contribute to the success of the American role in the new global “mail” marketplace?

Section 5: Challenges

The Postal Service's future mail volume growth is made uncertain by new competitors (both domestic and foreign), electronic diversion, new technological communication channels, and competitive products and services from other businesses. Today's mail volume is impacted in the short run by the current economic downturn. Beyond this near-term challenge, combined with continuing cost increases for labor, employee health care and retirement costs, transportation, and facilities, inadequate volume could continue to produce a gap between revenue and expense, with severe financial implications for the Postal Service

These issues will be addressed in the final Transformation Plan, where in-depth analysis of the financial and operational structures, human capital, and other challenges posed by the transformation options will be presented. The purpose of this section, Challenges, is to identify major considerations and issues that will contribute to the discussion and analysis that needs to take place before the end of year submission.

Operational Challenges

Transformation will require significant operational changes due to the fundamental role the operational infrastructure plays in serving the Postal Service's customers and the American people.

What structure encourages an efficient, affordable, and productive Postal Service?

The Postal Service is a massive organization. Each day, nearly 800,000 career and 100,000 temporary, casual, and other employees accept, sort, transport, and deliver more than 680 million pieces of mail to more than 135 million addresses. In roughly one week the Postal Service matches the annual volumes of United Parcel Service and in two days it delivers what FedEx delivers in a year. The Postal Service infrastructure includes 458 mail processing facilities and 38,000 post offices, stations, and branches. With its 205,000 vehicles, it operates the largest fleet in the nation, traveling more than one billion miles a year. It also purchases nearly \$5 billion annually in transportation services and is a major client of every domestic airline.

Postal Service Operations

The average American accesses the operational infrastructure of the Postal Service when receiving mail, when dropping mail in collection boxes, and when visiting retail locations to purchase stamps or mail packages. The movement of that letter or package from the mailbox or retail outlet to the addressee is accomplished through a complex, multi-network structure.

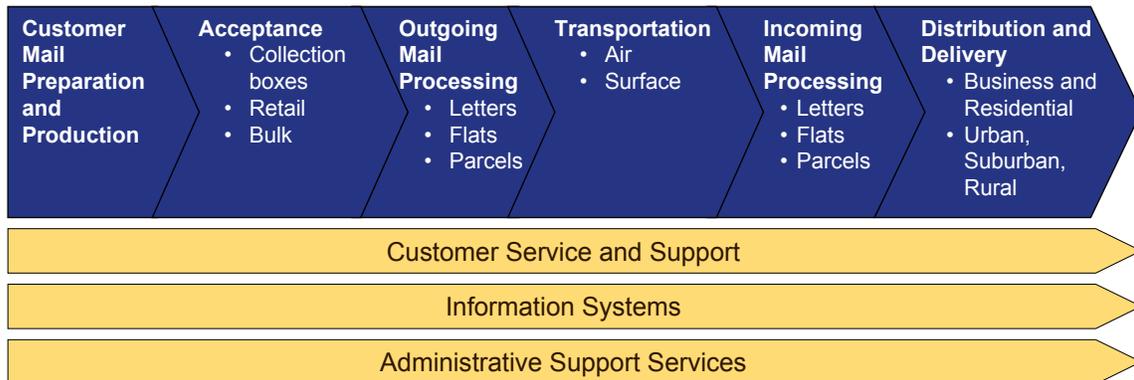
The Postal Service's networks of retail post offices, distribution/sorting plants, delivery offices (often housed in retail units), and air and surface transportation connections form the physical link

between the Postal Service and the 135 million American addresses. This set of networks operates whether there are 10 pieces of mail per address every day or one piece of mail per address every day. Obviously, the more volume in the system, the lower the unit costs. Resizing the network to accommodate growth (delivery points or mail volume) or decline is not a short-term proposition. This is especially true when the extent of resizing is constrained by the universal service obligation (discussed further in Section 2). In fact, there is probably a “floor” to the amount of resizing possible in an environment characterized by declining volume, increasing delivery points, and a universal service mission.

Manufacturing organizations react to declines in business by cutting back on production and shedding workers and other expenses. Service providers with significant fixed costs are less flexible, and the Postal Service, due to its universal service obligation to the customer, is significantly more constrained than most other service providers. For example, a letter carrier must deliver the route daily regardless of traffic on that route. Airlines, however, can decide, as they have in the past, to reduce network costs by eliminating points they serve or reducing the frequency with which they serve them. The Postal Service is not free to reduce its daily “flights.” It is prohibited, or severely constrained, in its ability to drop delivery points from its network, eliminate retail points from its network, reduce the frequency of delivery, or change time-in-transit standards.

The following chart illustrates the main processing steps the Postal Service employs to transport the mail from the customer to a final delivery point.

Postal Service Operations



Focus of Improvement Efforts

Mail volume workload and delivery points have increased significantly during the last 30 years. The workload growth has required considerable infrastructure expansion to support universal service. While mail volume growth and periodic price increases have contributed to the organization’s ability to pay for that expansion, the Postal Service has also been successful at

restraining costs by limiting work force growth. Despite mail volume increases of 139 percent and delivery point increases of 69 percent since 1970, postal employment has grown by only 24 percent. The result has been rate increases generally at or below the rate of inflation during the course of the Postal Service's existence.

The Postal Service has had a successful history of cost containment. Worksharing discounts, capital investments, network consolidation, productivity and growth management strategies have enabled the Postal Service to continue meeting its universal service mission with rate changes generally in line with the rate of inflation even though work load (volume and deliveries) growth during the same period has been substantial. A continuation of that success will be more difficult to achieve in the future, particularly if volumes decline as a result of electronic diversion and other market forces.

Regardless of which direction a changing environment takes, the main focus of operations strategies will continue to be providing mailers and recipients with excellent service at the lowest possible cost. Cost containment and productivity improvements are, therefore, the central themes of operations' strategies for any and all projected future outcomes. Key operational challenges of the Postal Service include variable and fixed cost containment, network optimization, service standards revisions, and mail processing automation.

Because of the relationship of operational fixed costs versus volume variable costs, the challenge becomes significantly more difficult to meet in times of declining volumes. Mail volume variability that results in economies of scale in a volume growth environment limits the Postal Service's ability to reduce costs in a declining volume environment.

Variable Costs

Historically, the Postal Service has offset substantial increases in labor costs, due both to wage rate increases and workload growth, through workshare discounts and automation. Although there are some opportunities for improvements, the majority of workshare and automation efficiencies in the current system have been realized. There are few opportunities for additional workshare discounts with significant effect on total operating cost.

Letter automation also has been effective in removing costs from the system. Remaining automation and mechanization opportunities for flats and material handling will have less overall impact. Because of lower projected absolute savings and the statutory borrowing ceiling, capital funds for investment and mechanization are limited. Since there is no indication that wage rates will rise more slowly in the future, total labor costs will grow despite continued efforts directed toward workshare and automation strategies.

Fixed Costs

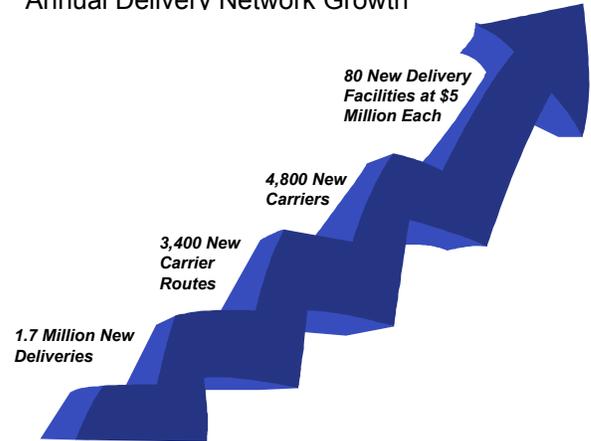
If the current interpretation of the universal service mission prevails, management has little control over the fixed infrastructure costs that this obligation entails. Maintaining present standards for speed, frequency and method of delivery, and access to services hamper any efforts to scale back the infrastructure in reaction to declining volume growth. Increased flexibility to make potentially unpopular, but necessary, decisions is ideal under all transformation phases.

Cost of the Network

Assuming no change in the universal service mission, the Postal Service must, on average, deliver \$1.85 worth of mail daily to each delivery address in order to support its current expenses. Simple projections of the future growth of postal expenses, using Consumer Price Index (CPI) and Employment Cost Index (ECI) estimates and calculating possible delivery growth on the basis of household formation, suggest that the

Postal Service will need to deliver \$2.46 of revenue per possible delivery per day, a 33 percent increase, to break even in 2010. On the surface, this increase does not appear to be dramatic. However, as mail volume growth continues to decline, revenue will still need to increase at a comparatively high rate to pay for the expanding network. The number of deliveries is driven by the universal service mission, and cannot be controlled. The arrow on this page is a graphic representation of the current annual growth experienced by the Postal Service as it meets its mandate to provide service to all addresses in America. The 1.7 million annual new addresses translate into an additional 500 deliveries for each of 3,400 new carrier routes. In turn, these new carrier routes require 4,800 additional carriers per year. To process the mail to be delivered, the Postal Service has to build 80 new delivery facilities at an average annual cost of \$5 million each. The Transformation Planning effort must help the Postal Service determine how it will meet these commitments in the future.

Annual Delivery Network Growth



Financial Challenges

The Postal Reorganization Act requires that postage rates be set to cover costs. This has been interpreted to mean that the Postal Service break even over time. This constraint limits the organization's ability to generate internal cash flow. As a result, many required investments must be funded through debt. Presently, the Postal Service can increase

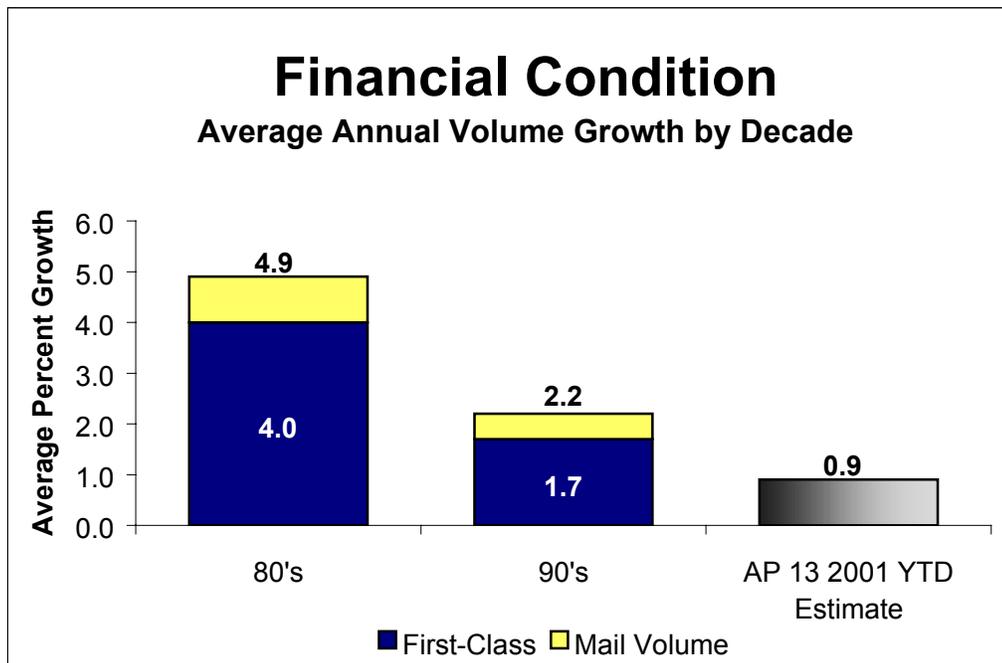
How will the Postal Service finance universal service as volume growth declines and costs continue to rise?

revenue by adjusting the rates of its products and services through a ratemaking process that takes approximately 18 months.

Financial Conditions

Despite the Postal Service's significant gains in efficiency and productivity through automation in recent years, Postal Service costs are rising faster than revenues. A diminishing growth rate trend of First-Class Mail has been made more severe by increased labor and fuel costs as well as structural changes in the American communications system, which are decreasing expected postal revenues. The recent softening economy has also had a negative impact. The costs of maintaining and servicing a growing universal delivery network have escalated. The universal service mission includes responsibility to serve many post offices and delivery points that are not self-sufficient.

From a financial perspective, the decline in the growth rate of First-Class Mail is alarming. The following chart illustrates the declining growth rate for both First-Class and total mail volumes.



As the chart depicts, annual First-Class Mail volume growth has slowed considerably during the previous decade, and there is no evidence that this trend is reversing. Looking at ten-year periods, from 1980 to 1989, First-Class Mail volume grew by 48 percent, which is an average annual increase of 4 percent. During 1990 to 1999, First-Class Mail volume grew only to 19 percent, an annual increase of only 1.7 percent. This is less than half the rate of growth seen in the previous decade. A comparison of fiscal year 2000 First-Class Mail volume data to fiscal year 2001 estimates shows that the declining growth rate is continuing. This monopoly product is of central importance to

the Postal Service's bottom line because its revenues are sufficient to cover a significant portion of overhead costs. First-Class Mail comprises 48 percent of total mail volume but accounts for 69 percent of current postal revenues.

A number of customers and stakeholders fear that the volume trends illustrated above will result in continuing price increases, which in turn will drive volume lower, necessitating additional rounds of price increases and subsequent volume declines. At current relatively low price elasticities for most core products, this "death spiral" scenario may not be imminent. However, as the communications, advertising, and logistics markets become more competitive, mail volumes will become more price elastic, making this scenario a concern for the entire postal industry.

Total labor costs, meanwhile, continue to rise. In efforts to control labor costs, since fiscal year 1999, the Postal Service has reduced its career complement by 27,457 employees, a 3.4 percent reduction. Through September 7, 2001, it reduced work hours by 23.1 million below the prior year, while mail volume has grown 1.1 percent. Further, on September 7, 2001, the Postal Service announced a complement reduction of 1,300 administrative positions. Nonetheless, in fiscal year 2000 labor accounted for 76.5 percent of total Postal Service expenses. As reported in the 2000 Postal Service Annual Report, the growth in compensation and benefits for 2000 was 4.6 percent. Although the final fiscal year 2001 increase in compensation and benefits is not known, three factors in particular affected the growth of these costs in fiscal year 2001. First, increased grade levels for 240,000 city letter carriers were implemented in November 2000 as a result of a binding arbitration award. Second, increases in the inflation rate during 2000 and 2001 resulted in higher than anticipated cost of living adjustment (COLA) payments. Finally, double-digit increases in health benefits costs added to the growth in compensation and benefits.

Through most of 2000 global oil prices also rose sharply, driving up refined fuel costs and the Consumer Price Index (CPI). The year 2000 CPI increase, the highest since 1990, triggered increased COLA payments for bargaining unit employees in accordance with contract provisions. In addition to higher fuel costs, the amount of fuel used by the Postal Service increased as the delivery network expanded by 1.7 million delivery points. Unlike energy-dependent companies in the private sector, the Postal Service can not respond quickly to these cost increases with temporary fuel surcharges, since all Postal Service rates are subject to review and regulation.

Postal Service management recognizes that even in difficult financial periods, its primary responsibility is to ensure that the American people continue to receive quality universal service at affordable rates. Addressing its revenue shortfall, the Postal Service acted early in fiscal year 2001 to freeze capital investment in needed new facilities and facility improvements³⁸, while pressing for additional efficiencies within the system. However, deferring these expenditures cannot be sustained over the long term and cannot substitute for needed revenue growth.

³⁸ A facility exception approval process was put in place to address emergencies, safety, and legal obligations.

In January 2001, the Board of Governor's implemented under protest the Postal Rate Commission's recommended rate increases and submitted for reconsideration as required by law. In July 2001, the Postal Service determined that it was necessary to institute a modified rate increase. At this time the Postal Service anticipates a net loss of about \$1.65 billion for fiscal year 2001, substantially less than would have resulted without the improved productivity and rate modification. Total factor productivity for fiscal year 2001 is expected to reduce expenses by \$1.2 billion. However, on September 11, 2001, still faced with continued increases in transportation, labor, and health care costs and a highly uncertain economy, the Board of Governors announced the filing of a new rate case with the Postal Rate Commission. The case was filed on September 24, 2001.

Financial Transparency

So that stakeholders and policy makers may follow the Postal Service's current and projected financial condition, a quarterly presentation of the Postal Service's financial results are provided on the Postal Service's website: www.usps.com.³⁹ The Postal Service's Fiscal Year 2000 Annual Report is also available on the website. In addition, hundreds of thousands of pages of official filings, which include extensive Postal Service revenue, cost, and pricing information, are available through rate and classification case filings posted on the Postal Rate Commission's website, www.prc.gov.

Debt Ceiling/Cash Flow Issues

Under current law the Postal Service may increase its outstanding borrowing by up to \$3 billion annually, which includes a \$2 billion increase for capital investments and a \$1 billion increase to defray operating expenses. The Postal Service is subject, however, to a total debt limit of \$15 billion, which has been in place since fiscal year 1992, when it was raised from \$12.5 billion. Prior to fiscal year 1991, the debt limit had remained at \$10 billion since postal reorganization. The law also requires the Postal Service to notify the Secretary of the Treasury at least 15 days prior to offering debt obligations. The Secretary has a right of first refusal to purchase the Postal Service debt within the 15-day period or a commercially reasonable time period thereafter. Since 1974, the Postal Service has borrowed exclusively through the Treasury's Federal Financing Bank.⁴⁰

Following 1992, debt declined for five consecutive years, reaching \$5.9 billion at the close of fiscal year 1997. By the end of fiscal year 2000, however, debt had risen to \$9.3 billion and year-end cash totaled almost \$700 million, equal to approximately one week of payroll. Postal Service debt is projected to rise both in fiscal year 2001 and fiscal year 2002, and may total more than \$12 billion by the close of fiscal year 2002, bringing it within \$3 billion of the statutory limit. This projection assumes

³⁹ The financials are available on <http://www.usps.com/financials/> or on the Home Page of the Postal Service web site through "About USPS".

⁴⁰ Leasing is also used as a financing vehicle. The Postal Service enters into leases in the normal course of business. As of September 30, 2000, capital and operating lease obligations totaled \$9.7 billion.

a continued freeze on construction of new facilities and no large net change in cash from the September 30, 2000 level.

The amount the Postal Service borrows is largely determined by the difference between its cash flow from operations and its capital cash outlays. The capital cash outlays are the funds the Postal Service invests back into the business for facilities and automation equipment. Capital investments are also necessary to maintain the existing infrastructure of facilities, equipment, and vehicles. Due to the linkage between borrowing, cash flow, and capital investments, discussion regarding an appropriate level of debt must take place within the context of plans for cash flow from operations and for capital investments.

The Postal Reorganization Act requires that postage rates be set to cover costs. This has been interpreted to mandate that the Postal Service break-even over time. The break-even constraint places an upward limit on the amount of cash flow that can be generated to pay for capital investments without borrowing. The fact that the Postal Service has not met its break-even objective (cumulative losses at the end of 2001 are estimated to be in excess of \$5 billion) has contributed to the rise in debt.⁴¹

The rate-setting process attempts to address prior year losses by including an allowance in each rate case to recover a portion of losses, currently set at one-ninth. Since the amount of the allowance is recomputed with each rate filing, the process will never allow the Postal Service to recover the losses in their entirety.⁴² Revenue growth driven by mail volume growth would, in theory, be the most effective way for the Postal Service to generate progress toward positive equity. Net income will translate into improved equity, dollar for dollar.

Sustained revenue and cash flow growth would not require borrowing to fund the capital outlays that are driven by the universal service mission and by the need to invest in cost-saving initiatives, including new technologies. In light of various technological and economic risks to mail volume growth, which create risks to cash flow, the Postal Service's capacity to service growing debt is highly uncertain.

Finally, access to credit is an important issue that will influence the long-term viability of the Postal Service. If the Postal Service were to borrow in the public bond markets, those markets' assessment and pricing of Postal Service credit would depend heavily on the Postal Service's structure and ties to the government. Numerous experts outside of the Postal Service have suggested that if the Postal Service became a private company, the focus of attention would change from the ability to rely on the United States government as a source of financial strength to include

⁴¹ It is important to distinguish between debt, which measures borrowed funds, and equity, which is equal to the government's \$3 billion capital contributions plus all net incomes minus all losses since reorganization. At the end of fiscal year 2000, Postal Service debt totaled \$9.3 billion and its equity totaled negative \$646 million.

⁴² The current practice has evolved over the course of a number of rate cases, involving input from the Postal Service, the Postal Rate Commission, and the Court of Appeals.

greater emphasis on the earnings power and capital structure of the privatized organization. The GAO's publication regarding the Tennessee Valley Authority (TVA) also supports this view.⁴³

The experience of government-sponsored enterprises, such as Fannie Mae and Freddie Mac, and the GAO's study of TVA, indicate that, when a borrower maintains a relationship with the government, that relationship tends to define the perception of the organization's credit in the market, although financial performance is also monitored. Rating agencies and investors would assume a reasonable probability that the government would step in to repay debts if the borrower failed to do so. In the case of a privatized Postal Service, the rating agencies would assess the fundamental ability of the organization to generate the cash needed to service its debt. Rating agencies would also look at the reliability of external financing sources, as well as other sources of liquidity inherent in the Postal Service's balance sheet. Nevertheless, the rating agencies would probably also continue to assess the Postal Service's public policy value and assume, to some degree, that the government could provide some means of repayment in the event the Postal Service was unable to fulfill its public policy obligations. Depending on the structure of the entity, this would be viewed as an "implicit" backing of the government, similar to the backing the rating agencies and investors assume for other government-sponsored-enterprises, such as Fannie Mae and Freddie Mac.

The question has been raised whether the current \$15 billion statutory debt limit is appropriate for the Postal Service and, if not, what limit would correctly reflect the Postal Service's capacity to service debt without difficulty. As stated earlier, the Postal Service's capacity to service growing debt is not certain. That said, the issues associated with the Postal Service's debt limit are quite complex and benchmark comparisons with private sector companies are difficult, largely due to the Postal Service's break-even mandate and to private sector reliance on equity. Equity provides companies with a stable source of funds and also leads to a focus on creating value for shareholders by generating cash flow and profits. The debt ceiling and borrowing authority of the Postal Service will be analyzed in the Comprehensive Transformation Plan.

Increasing competition, shrinking market share in some product areas, growing diversionary threats, rising labor and fuel costs, and expanding service responsibilities combine to pose this stark question: *How will the Postal Service finance universal service as volume growth declines and costs continue to rise?* The answer to this question lies not only in financial structure, but in the Postal Service's ability to leverage and manage its extensive workforce.

⁴³ United States General Accounting Office Report to Congressional Requesters, GAO-01-540, *Tennessee Valley Authority Bond Ratings Based on Ties to the Federal Government and Other Nonfinancial Factors*, <http://www.gao.gov/new.items/d01540.pdf> (September 2001).

Human Capital Challenges

This section discusses the human capital challenges facing the Postal Service. The term “human capital” refers to the skills and knowledge of the workforce and the ability of the organization to apply those skills and knowledge to meet corporate objectives. In a labor-intensive enterprise like the Postal Service, human capital strategies, such as workforce planning, training and development, compensation, and labor relations, are fundamental drivers of success or failure. When those strategies are constrained, by law, culture, or market pressures, the organization struggles.

How should the human capital requirement of the future Postal Service be met?

Challenges: General

Of the Postal Service's 778,000 career employees, approximately 694,000 (89 percent) are covered under collective bargaining agreements.⁴⁴ The four largest unions are the American Postal Workers Union (APWU), National Association of Letter Carriers (NALC), the National Rural Letter Carriers Association (NRLCA), and the National Postal Mail Handlers Union (NPMH). Both the size and strength of the labor unions are significant. Compensation and benefits account for more than three-quarters of total postal operating expenses,⁴⁵ making the financial health of the organization highly contingent upon the Postal Service's ability to manage its labor force.

The Postal Service is under intense pressure to control labor costs through a variety of means, including wage and benefit moderation, work rule changes and workforce planning flexibility. Successfully responding to increasing labor cost pressures, while simultaneously fostering workplace environment improvements, will undoubtedly continue to be one of the most significant challenges for the Postal Service. According to the GAO:

The Postal Service's human capital issues can be seen as part of a broader pattern of human capital shortcomings that have eroded mission capabilities across the federal government. The Postal 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.⁴⁶

⁴⁴ Labor Relations Department, “Summary Number of Bargaining Unit Employees” (Washington DC: U.S. Postal Service, September 2001).

⁴⁵ United States Postal Service, *2000 Annual Report*.

⁴⁶ *U.S. Postal Service: Transformation Challenges Present Significant Risks* (GAO-01-598T) Testimony of Comptroller General David Walker before the Committee on Government Reform House of Representatives, April 4, 2001: p 15. (Appendix A.)

The Postal Service continues to develop and implement numerous strategies to facilitate organizational alignment and integration of human capital with the agency's mission, goals, objectives and core business strategies. Accomplishing that task, however, will likely be more difficult in the future if, as many predict, mail volumes stall or decline and cost pressures force reductions in complements, training budgets, and compensation-based incentives. In such a scenario, the incremental improvements of the past may no longer be sufficient.

Although it is not covered by most of the components of the federal civil service personnel system, the Postal Service shares some of its shortcomings. President George W. Bush's Management Agenda for 2002 could have been addressed to the Postal Service. The President said:

We must have a Government that thinks differently, so we need to recruit talented and imaginative people to public service... We'll establish a meaningful system to measure performance. Create awards for employees who surpass expectations. Tie pay increases to results. With a system of rewards and accountability, we can promote a culture of achievement through the Federal Government.⁴⁷

That is the environment the Postal Service and its Board of Governors have been trying to create. It is a significant challenge, however, to apply these business-oriented philosophies to a human capital infrastructure that is constrained in ways that most businesses are not.

Workforce Planning: General

The Postal Service is facing major marketplace challenges as it enters the 21st century. As the previous section indicates, mail volumes may stall or decline but the value of the mail could increase if the Postal Service is considered a crucial component of its customers' communications, advertising, and logistics networks. In this environment, workforce planning efforts must focus on flexibility, because total workload requirements are decreasing and becoming more difficult to predict and on recruitment and skills development, because the nature of the work is becoming more specialized and strategic and less repetitive/transactional.

As a result, the Postal Service is reexamining its focus and its organizational structures, and is streamlining where appropriate. Planning efforts involve identifying the skills and talents that will be necessary to accomplish the Postal Service mission, while determining how to redeploy talent, attract the skills that do not currently exist, and, as necessary, divest labor costs associated with redundancies.

While the overall number of postal employees will continue to be reduced through attrition, this reduction will not leave the Postal Service with the exact skills sets necessary to perform its mission. Finding ways to realign the existing workforce to meet complement needs has not always been efficient. Mismatches in this area can strain the continuity of core business. Despite the

⁴⁷ "The President's Management Agenda, Fiscal Year 2002," p 11.

continued need to streamline operations, the Postal Service must implement recruitment strategies for positions that require a specialized skill or talent widely sought in private industry and by public sector employers.

Complement reduction efforts to control labor costs have required implementation of a Reduction-In-Force (RIF). Implementing organizational changes involves a certain degree of complexity, since the Postal Service is required to follow certain statutory requirements. When using RIFs as a complement reduction tool, specific process steps must be followed in order to comply with applicable laws and regulations. A RIF, while providing a systematic approach to streamlining complement where needed, is a lengthy process that is disruptive to the organization, and does not necessarily provide sufficient flexibility when making necessary organizational changes. Other options for cost control exist.

Outsourcing as a response to cost pressures is an option the Postal Service can and will pursue when appropriate. Past experience has shown that flexibility in using this tool is limited. A final element of human capital flexibility is less tangible; it is the extent to which the culture of an organization tolerates, or even promotes change. For many reasons tied to the potentially conflicting blend of public policy and business objectives, its break-even constraint, and the public importance of the services it provides, the Postal Service is risk averse. If the markets in which the Postal Service operates begin to change dramatically, the culture of the organization must change as well.

Even while the Postal Service is reducing its workforce, it will need to recruit people with specialized skills and talents from a diverse applicant pool to help the organization respond to increasingly sophisticated customer requirements. It is hampered in this effort, however, by a number of constraints: salary caps restrict compensation; stock options are not available; and the organization suffers from the perception that its very size and association with government make it a less than promising place to launch a career.

In the area of skill development, the Postal Service has implemented state-of-the-art training and development programs, such as the Advanced Leadership Program, the Postal Service Training Network (PSTN), eLearning, and other residential and distance learning efforts. These training and development strategies will need to continue at appropriate levels for on-the-job training, to both develop talent and leadership that parallels succession-planning requirements, and to supplant the loss of talent through attrition and complement reductions. Funding these skills development programs will be a challenge.

Workforce Planning: Executive and Administrative Employees

The Postal Service anticipates that technological improvements, particularly in field operations and administrative functions, and adoption of efficient shared services models for administrative functions will result in complement reductions in non-bargaining supervisory, administrative, and other management positions. Workforce reduction efforts are thus focusing on

positions where workload has diminished because of decreased mail volume, technology substitution, work consolidation, or economic downturn.

Approximately 39 percent of the Postal Service's non-bargaining workforce will be eligible to retire through year 2005. This percentage does not account for those employees who may leave for reasons other than retirement. With this potential exodus, planning efforts have been focused on identifying and developing talent to fill critical positions. The Postal Service has developed both executive and managerial core competencies and has addressed and communicated a common and consistent understanding of what skills are needed for internal career development.

Compensation

Prior to 1970, postal compensation was identical to that found in the rest of the federal government. The Postal Reorganization Act, however, implemented a general standard of pay comparability to the private sector and a new system of collective bargaining for determining changes to bargaining-unit compensation within the comparability standard. In several key respects, however, the statute retained ties to the civil service.

Several provisions of the Postal Reorganization Act linked postal compensation directly to federal practices. For example, the maximum salary is tied to Federal Executive Level I, the same level as members of the President's Cabinet. In spite of salary caps and other constraints, the Postal Service has pioneered pay-for-performance programs (variable, merit, and recognition pay) in the federal government and in this way has driven substantial organizational success by aligning compensation with performance. However, the unfamiliarity of these programs in a break-even environment can invite misunderstanding and misgivings within the federal oversight community.

Compensation rules for labor that existed prior to the reorganization were preserved unless changed through the collective bargaining process. If either party in the collective bargaining process proposes changes to which the other party will not agree, the issue is left to an arbitrator. Arbitrators in the collective bargaining process have generally been averse to making major changes to current practices. The challenges inherent in the collective bargaining process for bargaining unit compensation are further discussed later in this section.

Other than the territorial allowance for employees outside the contiguous 48 states, nation wide pay scales do not allow for differentiation of pay by local labor markets. Certain postal benefit plans are tied by law to federal programs, e.g., retirement, which restrict the Postal Service from designing cost-effective programs to serve strategic organizational needs. Despite its limitations, the Postal Service has been in the forefront of the federal community in making compensation changes. *Government Executive* magazine has characterized the Postal Service as a leader in tying pay to results. Although the Postal Service has made progress in meeting its compensation challenges, opportunity still exists for improvement.

Workforce Planning: Labor

While every indication is that the need for administrative staff will continue to diminish, internal and external environmental situations will demand that workforce plans also include replacement strategies for certain bargaining unit positions. Operating requirements will demand a degree of flexibility in using the existing workforce on assignments that are critical to the Postal Service mission. Technological improvements in processing operations have decreased the need for certain clerical positions. However, to maintain the universal service mandate, maintain operations, and meet the challenge of ever increasing points of delivery, certain skill sets will be critical. The Postal Service will need to address cost efficient ways to move people from positions that are no longer necessary to positions that remain critical. Management will need to monitor attrition projections for bargaining unit positions where a specialized skill and/or license is required. Since specialized skills, especially in the area of maintenance, are also in demand in both private industry and the rest of the public sector, the Postal Service will still have recruitment challenges.

Collective Bargaining

The current procedure for final and binding arbitration ensures that a resolution to a dispute will occur without any disruption to the operations of the Postal Service. The process allows for fact-finding and mediation that can produce an agreement between the parties. In addition, the primary positive feature of this procedure is that it functions as an alternative to strikes and lockouts, thus avoiding the economic damage that results from such actions.

The current binding arbitration procedure also presents a number of challenges for the Postal Service. By its very nature, interest arbitration puts decision making in the hands of a third party arbitrator. Unlike the parties to the labor agreement, the arbitrator does not have a personal stake in the outcome of a decision. Neither does the arbitrator have to be concerned with the long-term viability of the organization or the parties' ongoing relationship. In addition, the Postal Service bargains with a number of unions at separate, independent negotiations. This can lead to inconsistent results, which hamper management's flexibility or increase costs. A gain made by one union may be used to "whip-saw" the organization and gain similar provisions in other units.

Throughout the collective bargaining history of the parties, a number of improvements have been achieved utilizing the binding arbitration model. These changes include:

- Expanded use of part-time employees in the city carrier craft to increase workforce flexibility, allowing management to better staff and schedule resources consistent with workload
- Doubling the percentage of part-time employees in the clerk craft, which will also increase flexibility
- Limited ability to lay off employees

- Expanded flexibility through the creation of temporary non-career transitional employees
- Reduced Postal Service health benefit contributions
- Reducing somewhat the wage premium gap that has existed for more than twenty years. That progress has been largely offset by a continuing benefits premium, so that when viewed in the context of total compensation, there has been only a modest closing of the total compensation premium

While the Postal Service has had a number of successes in making interest arbitration more flexible, from management's point of view there have also been instances of unfavorable awards for the Postal Service. The potential financial significance of some of these awards is not nearly as visible as are other aspects of postal operations.

Examples of the major decisions that have resulted from recent arbitration are:

- An independent arbitrator upgraded all city letter carrier positions in an interest arbitration award, which occurred as a result of the last negotiations with that union. That award was a significant impediment to subsequent settlements with other unions wanting an upgrade like the NALC.
- An earlier, separate interest arbitration award upgraded utility carriers, who deliver on five different routes.
- NALC transitional employees received COLA as a result of the 1992 interest arbitration.
- COLA provisions have continued in the Postal Service's labor agreements despite prodigious efforts to eliminate them.

Under current law, the Postal Service's strategy is to seek positive change while maintaining the beneficial aspects of the existing procedures. The Postal Service believes that realistic changes can be made that will enhance the current collective bargaining process. These changes can streamline the current arbitration procedures by imposing standards for the selection of a neutral party and by shortening the arbitration process. Dramatic change proposals that cannot be accomplished are of no value.

Human capital challenges are just one component of a comprehensive list of issues that must be addressed in developing a transformation plan. The next section addresses operational, financial and human capital strategies that the Postal Service might examine for each of three parallel phases of postal transformation.

Section 6: Transformational Phases

Given the challenges outlined in Section 5, how should the Postal Service be transformed to best serve its customers? This *Outline for Discussion* outlines three possible phases:

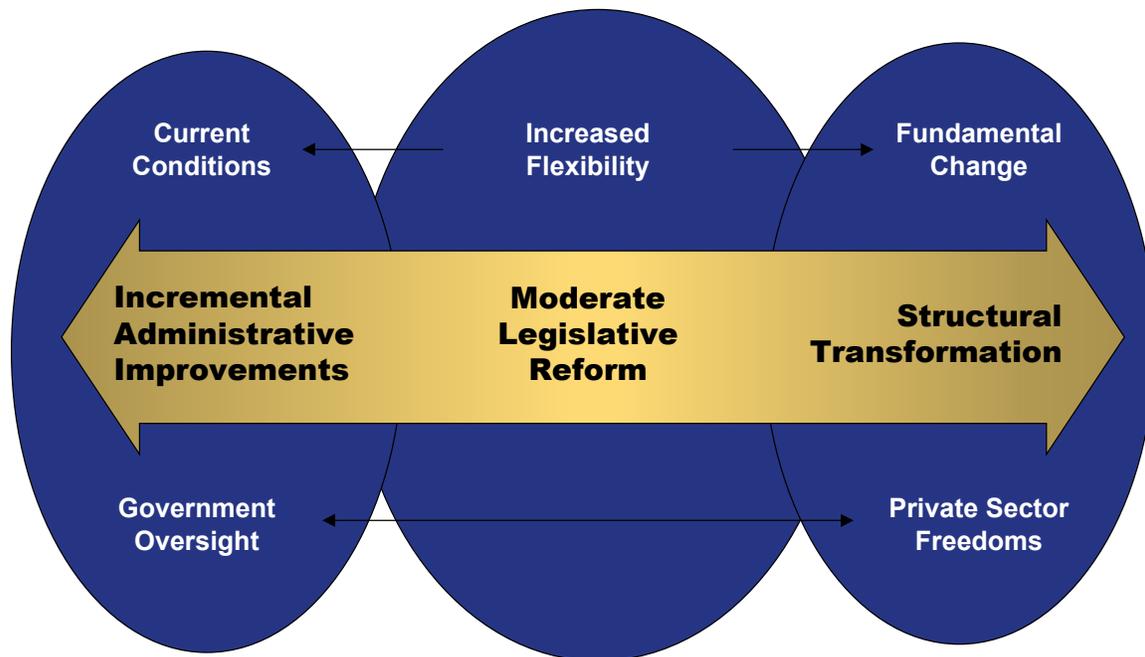
How should the Postal Service be transformed to best serve the American public and the mailing industry?

- *Incremental Administrative and Operational Improvement* – Actions that can be taken to improve postal services and postal finances without changes to the current law.
- *Moderate Legislative Reform* – Statutory changes that provide the Postal Service more pricing and operational flexibility in exchange for incentive regulation to moderate price increases and, potentially, a reduction in the scope of the monopoly.
- *Structural Transformation* – A fundamental change in the mission, obligations, governance structure, and/or regulatory framework of the Postal Service.

As a practical matter, transformation of a large institution is likely to take place one step at a time. It is logical, therefore, to think of these phases as sequential. Many stakeholders, however, believe that this approach could delay critical, long-range transformational decisions that must be made now. This *Outline* therefore considers these options as “parallel phases” and invites stakeholders to consider all three as potential solutions to current postal challenges.

Within each of these phases there is a range of alternative approaches that might be taken to address issues such as the scope of universal service or the governance structure of the Postal Service. For example, fundamental structural transformation can take many forms, as there are transformation models from other Posts and from other regulated industries that range from incorporated government entities to fully privatized businesses. At issue is what represents the best approach to take in shaping the postal model of the 21st century. These alternatives must be considered by the Postal Service Board of Governors and management, the Administration, Congress and, ultimately, by the mailing community and the American people.

The broad range of possible choices is illustrated below.



For each of the three phases, the postal community must consider its core assumptions and assess strategies for operations, finance, pricing and human capital. All of these components are interrelated, and all can be defined only in the context of the broader question of how the Postal Service should be transformed to better serve its customers and constituents.

Phase One: Incremental Administrative and Operational Improvement

This phase considers business and operational improvements within the legal and public policy framework that exists today. The Postal Service is already taking action, using existing authorities to reduce costs, increase efficiency, and generate new revenue.

Assumptions

Delivery scope and frequency, service standards, retail access, uniform rate requirements, and the security of the mail will remain as they are today. The Postal Service will continue to focus on core products and services and enhancements designed to improving reliability, ease of use, and tracking. Major new product offerings are not expected under this phase. Declines in volume or unexpected increases in costs will be offset by increases in price and continued investment in costs reductions and efficiencies.

Operations

Cost reductions and increased efficiencies are the primary focus of this phase. The Postal Service has achieved productivity improvements sufficient to provide universal service while keeping rate increases generally in line with inflation despite substantial workload growth. To ensure success in a baseline scenario, the Postal Service has developed some bold actions to take within current constraints. Some examples of these plans include:

Worksharing: The Postal Service will continue to look for opportunities to partner with the mailing industry to reduce costs through pricing incentives and classification changes. Recognizing that opportunities to reduce internal mailer production costs can positively impact the volume of mail, stakeholders have identified mailing requirements changes that can reduce both Postal Service and mailer costs. In addition to new and enhanced discount programs resulting from the recently announced rate filing, there are plans for a significant product redesign effort designed to recognize changing customer needs and to take advantage of expanding mailer capabilities. In addition to providing products that better meet customer requirements, the Postal Service will endeavor to “rationalize” the classification schedule to motivate mailers to produce mail that is compatible with the most efficient processes.

Capital Investment: The Postal Service will continue to pursue opportunities to improve already highly efficient letter operations. For example, the development of the Postal Automated Redirection System (PARS) will use advanced information technology to intercept undeliverable-as-addressed mail earlier in the sorting process and thus reduce the number of handlings and associated costs. The Postal Service will also focus investments on other labor-intensive operations. The latest generation of flats sorting equipment that provides additional capacity and offers substantial increases in productivity over the older generation of equipment is being deployed nationally. Plans will be implemented to add automation capability and automatic feeders to those flats sorting machines designed to process over-sized flats and to add automated carrier delivery sort features for flats similar to those successfully implemented for letters.

Allied operations, those not directly involved in individual piece distribution, are some of the fastest growing cost centers and also targets for capital investment. Currently under development is the next generation of the small parcel and bundle sorter that will incorporate automated capabilities for productivity gains. Also being developed are various material handling systems designed to reduce the dependence on manual labor for moving mail within processing facilities. Examples of systems currently under development include a Direct Connect System that will link canceling and barcode sorting equipment, and a Universal Transport System capable of moving letter trays, flats tubs, sacks, and individual parcels throughout processing facilities.

Network Consolidation: While continuing to look for opportunities to streamline networks through consolidation initiatives, the Postal Service is committed to a comprehensive examination of all distribution and transportation networks. Given the complexity of those networks, efforts in this area will take time to produce results, but significant cost savings opportunities will be identified. In addition, aggressive transportation strategies to move more mail onto a shared surface network and improve overall utilization of the transportation assets are being pursued.

Productivity and Growth Management: The Postal Service has undertaken a comprehensive cost reduction program which focuses on identifying best practices within specific operations, creating standardized procedures within those operations and then requiring use of those standardized processes at all facilities. Additionally, the Postal Service is aggressively pursuing the development of information systems designed to provide line managers with the metrics and feedback mechanisms necessary to manage operations.

Finance

Under this phase, the Postal Service will focus on financial strategies that are permitted within the existing legislative framework. These strategies are designed to reduce administrative costs, generate sufficient income to recover prior year losses (currently estimated at \$5 billion through fiscal year 2001), and increase cash flow. The greater cash flow could be used toward capital investment and debt reduction. For example, the Postal Service is considering providing administrative services to field and headquarters organizations through consolidated shared services centers. This approach will standardize and automate administrative functions, reducing redundancy and transaction times and therefore costs. As the Operations section above indicates, the Postal Service will also work aggressively to reduce operating costs. The objective of these bold actions – and of price increases, if warranted – will be to earn sufficient net income to recover prior year losses and produce the cash flow necessary to fund certain investments and reduce debt.

Pricing

Pricing will follow the current regulatory structure. The revenue requirement and prices will be determined by the Board of Governors, subject to review by the Postal Rate Commission. Small changes in rates and classifications will continue to occur with each rate filing. The Postal Service might also initiate significant product reclassifications as customer requirements and market conditions warrant. There is considerable discussion in the stakeholder community regarding the extent to which the ratemaking process may be streamlined or otherwise improved without legislative change, but at this time there is no consensus regarding how much flexibility exists in the current regulatory framework.

Under existing authority, the Postal Service could pursue a number of specific pricing initiatives, for example:

- Introductory pricing: New products and services (e.g., delivery confirmation and CONFIRM) could be introduced through initial rates that ease market entry and help create market interest.
- Transportation container rates: Zone transportation pricing would allow mailers to commingle various mail classes on one container and pay for the transport of that container to destinating facilities.
- Phase-in pricing: Price increases could be phased in over time for business mailers giving more predictability to price increases.
- Limited negotiated service agreements: Through experimental rate cases, the Postal Service could pursue pricing agreements for specific large volume mailers. This could be done through the reclassification process, assuming the rate change was cost-justified.

Human Capital

The implementation of incremental administrative improvements will be a framework within which the Postal Service will continue to implement a series of administrative actions to continue to reduce costs and improve efficiency beyond the historic high levels that have been achieved in recent years. Respect for the dignity of individuals, valuing diversity and an emphasis on continuous improvement of safety performance will continue to be core values and the focus of the organization. Significant restructuring has already been undertaken to reduce administrative costs and improve the efficiency of field operations. At the operating level, in the absence of authority to determine workforce changes except through the current collective bargaining process, more contracting out of services might be explored.

The existing system encourages continued exploration of shared service arrangements that promise to reduce costs and to improve administrative efficiency. Opportunities to reduce costs through investment in e-Service arrangements to automate the backend processing of administrative functions will increase. Such arrangements are currently being explored in the areas of benefit administration. The outsourcing of functions such as EEO complaint investigations will continue on a step-by-step basis. Other opportunities to reduce costs such as increased attention to attendance management will continue to be refined.

Administrative reductions will take place utilizing Reduction-In-Force (RIF) strategies to align workforce with workload. Training and development programs will be similar to those in place today that focus on advanced leadership development, supervisor training, and the reestablishment of internship programs.

Statutory salary caps will still exist, but might be relaxed within the constraints of maximum federal compensation limits. This relaxation could help the Postal Service attract and retain senior executives. Pay for performance will likely remain limited to non-bargaining unit personnel. Efforts to reduce labor compensation premiums relative to the private sector will continue through the collective bargaining process that is in force today. Benefits will still parallel other federal programs, though some moderate changes in health benefit contributions or annual and sick leave reform could occur.

The right to strike will not exist. Craft employee pay will still be based predominantly on steps and grades, without regard to locale. Binding arbitration will continue with moderate improvements. One proposal for modification of the arbitration process has included the utilization of one mediator, selected by the Secretary of Labor, to create a mediation-arbitration combined process. With this improvement, the length of the arbitration process might be shortened to reduce the uncertainty experienced under the current system.

Phase One Implications

Early discussions with stakeholders have highlighted some strengths of this phase, but only if volumes and contribution continue to increase.⁴⁸

- The American public will continue to receive universal service as currently defined.
- The nonprofit mailers will continue to receive preferred rates.
- The Postal Service will be a stable employer.
- The Postal Service will remain a major government purchaser for suppliers.
- The Postal Service will continue to support the mailing industry.
- Prices will be determined using the familiar rate making process.

Although the Postal Service is already implementing plans to increase efficiency, some stakeholders believe that the current model is not sustainable in the long term if mail volumes decline because of electronic diversion, increasingly aggressive competition, and/or weakening economic conditions. The following are possible negative implications of this phase:

- Increases in per-piece costs resulting from declining volumes and fixed universal service obligations could necessitate service reductions and large rate increases.
- Revenue shortfalls could limit investment in plant, equipment, and information systems. Future service and productivity improvements would be placed at risk, threatening price stability.

⁴⁸ This discussion of the implications of these phases is not meant to be definitive. By including this summary of the pros and cons that have emerged from early discussions with stakeholders, the Postal Service seeks to encourage comment that will guide analysis of the different phases.

- Sharp declines in mail volumes could result in significant job losses in the Postal Service and the mailing industry.
- Mail volume diversion could result in “residual” mailers paying for the remaining fixed costs of the universal service infrastructure.
- The Postal Service might reach its legal debt limit quickly and then fail to make current payments such as salaries.
- Direct government subsidies might be required.
- Adversarial labor/management relations could result from the required aggressive cost-cutting policies.
- Complex regulatory constraints on product development and pricing would continue to make it difficult for the Postal Service to react to changing customer requirements.

Phase Two: Moderate Legislative Reform

This phase includes moderate legislative reform designed to improve the flexibility and competitiveness of the Postal Service. Universal service may be more strictly defined. Governmental

How can the future postal system become more commercial?

controls would allow for increased Postal Service management discretion over the distribution and transportation network. Additionally, this phase might include separate regulatory frameworks for competitive and market dominant products. Non-postal or competitive products might be offered through newly created business units, initially owned by the Postal Service.

In addition to offering its enhanced core products, the Postal Service might also look for opportunities to enter complementary markets, such as logistics. If volume diversion were to accelerate, such investments in complementary markets would increase in efforts to combat revenue erosion due to substitution.

Potential transformational strategies associated with this phase are found below.

Operations

Implementation of enhanced productivity and network optimization efforts discussed in Phase One will continue. In addition, the Postal Service would pursue opportunities to push the current limits on dramatic change. Each of the following depends to a greater or lesser degree on overcoming real or perceived constraints from the universal service obligation or related legislation.

Networks: In order to control fixed costs as volume declines, it is necessary to have the capability and the flexibility to optimize the distribution network. The Postal Service must be able to logically

determine the number, size, location, and role/function of all plants and other facilities in the network and make significant changes where necessary. This would require enhancements to Postal Service information systems, labor flexibility in moving or laying off workers, and the ability to close or downsize facilities fairly rapidly.

Transportation network optimization is also a key strategy. The ability to successfully move mail from air to surface transportation depends ultimately on the Postal Service's ability to manage and rationalize service standards.

Service Standards Revision: The current standards for speed of delivery for various classes of mail require some very costly procedures in collecting, sorting and transporting mail. In order to ensure that the most cost efficient methods possible are consistently applied, those standards need to be reviewed on a regular basis relative to customer requirements. The flexibility to make significant targeted changes to those standards would be critical to successful cost containment. The ability to implement changes as drastic as eliminating overnight service, adding days to current standards, or reducing service commitments in specific geographic locales would be required. This ability will ensure not only lower costs, but also promote better consistency in the service provided.

Capital Investment: Automation of letter mail has reduced the cost of that mailstream significantly. There are additional automation or mechanization projects that have potential for further reductions in the cost of processing other mailstreams. The restrictions on capital available for investment have hindered efforts to test and implement some of these cost reduction projects.

Delivery: Some stakeholders have suggested that delivery frequency would need to be addressed. Current costs and a major portion of the future growth in costs are directly related to the requirement to deliver mail to every address every day. The ability to approach this requirement rationally and determine the most cost efficient frequency for delivery based on actual customer need would serve to reduce costs significantly. This would suggest case-by-case analysis based on geographic factors rather than a standardized approach. Models already exist for providing efficient and effective residential and commercial services that differ according to local need.

Stakeholders, likewise, have discussed delivery methods. Current costs and a major portion of the future growth in costs are directly related to existing methods of residential delivery. The various delivery services, for example post office boxes, rural delivery or city delivery, vary widely in the system costs they incur. Similarly, the differing residential deposit sites such as door slots, curblin boxes, or centralized boxes have significantly different costs that have been a well-documented part of fixed costs. The ability to require changes to currently established methods of

delivery based on specific customer need as well as cost efficiency would allow substantial improvements in cost control.

Access: Stakeholders have also discussed the potential need to redefine access requirements. Fixed costs are directly related to the requirement to maintain local post offices in areas where it is not cost effective to do so. The Postal Service would implement strategies that make small post offices more self-sufficient. Additional government/community services might be provided for a fee and commercial services such as banking may be included as well. When self-sufficiency is not possible, alternative methods of ensuring access to postal products and services would be implemented before offices are closed. Distance or density criteria might be utilized in lieu of one-for-one community post office requirements. New technology and developing business alliances could provide excellent access to products and services without maintaining expensive infrastructure. The ability to utilize alternate methods to ensure that all customers have convenient access would be critical to managing fixed infrastructure costs in a period of declining volumes.

Outsourcing: The Postal Service would also examine leveraging outsourcing capability. There are numerous identified and potential opportunities to contract out specific tasks or complete functions (from particular janitorial services to the entire operation of processing plants) to avoid the costly premiums in Postal Service wages. Increasing cost effectiveness would depend on the ability and flexibility to make rational business decisions regarding non-traditional outsourcing strategies.

Finance

In this phase, the Postal Service's financial objective would be to maximize profits given the universal service obligations and regulatory constraints, e.g., price caps, defined in the reform legislation. The Postal Service would use its profits and cash flow to reinvest in its operations, reduce its debt, and perhaps purchase equity in related businesses, for example, through joint ventures. If new legislation permits, the Postal Service might also create an independent business unit for either competitive products or competitive operations (e.g., the transportation network). If this approach were taken, separate, audited accounts would be required to prevent cross-subsidy from monopoly to competitive businesses. Postal employees might be offered an equity stake in this independent business unit through an Employee Share Ownership Plan (ESOP). The Postal Service would use additional freedoms granted in the envisioned reform legislation to restructure its balance sheet, using private-sector financial instruments as appropriate.

Pricing

The pricing mechanism would be changed to allow greater flexibility, for example, by using price caps as opposed to the current cost-based methodology. Price caps could tie maximum price

increases of bundles of products to specific market indices (e.g., the Consumer Price Index). Typically, productivity factors are included in price caps requiring efficiency gains on the part of the Postal Service. Major product reclassification would occur to encourage mail preparation changes and to facilitate process standardization and productivity improvements. Pricing and classification flexibility would encourage accelerated product introduction and innovation and the development of customer-specific product solutions. Contract pricing could be pursued more aggressively under this phase allowing the Postal Service to customize prices for key customers.

The regulator would continue to play a role in rate changes, albeit in a less direct way than at present. The regulator would determine relevant public policy criteria and rate hearings would only be held if the regulator received a credible complaint that the Postal Service had not adhered to those criteria.

Human Capital

Workforce strategies that would be implemented in a moderate legislative reform phase would be similar in many respects to those implemented in Phase One. Administrative authority and the collective bargaining process would be used to seek additional opportunities to improve efficiency. Some stakeholders have suggested that even moderate reform of such limits as pay caps and the use of financial incentives would have a significant benefit in contributing to performance.

Under existing law there is an opportunity to provide significant bonuses for such achievements as major productivity improvements. But the public sector management framework that has governed the Postal Service has limited the use of such authorities. Under moderate reform, explicit authorization for the use of such tools could be clarified.

Similarly, ESOP plans could be authorized under the framework of moderate reform. If reform permits the creation of a separate private corporation for non-postal products, as has been suggested in some reform proposals, more market-based workforce strategies that would create incentives for management and the work force could be implemented in such a private sector framework.

One of the proposals that has been suggested in past reform efforts has been the creation of legislative guidance for the President in the selection of the Board of Governors. Stakeholders have commented that Board membership in some public enterprises requires specific types of experience, such as experience managing large corporations.

Finally, it should be noted that there has been limited attention given to legislative changes that would address human capital in the discussion of reform during the past five years. Comments from a number of stakeholders have suggested that there will be a need for more fundamental changes in the Postal Service model if there should be reform in the current human capital policies and procedures.

Phase Two Implications

Early discussions with stakeholders have highlighted some strengths of this phase:

- The American public would continue to receive universal service.
- These reforms would increase market discipline and reliance on new product development and innovation.
- The Postal Service would continue to be a stable employer.
- The Postal Service would remain a major purchaser for suppliers.
- The Postal Service would continue to support the mailing industry. Prices would be more predictable, with smaller, more frequent increases.
- Pricing flexibility could be used to manage volume and workload, thus optimizing the network and reducing costs.
- Employees affected by mail volume losses could be retained and re-trained if the Postal Service enters new markets.

The following are possible negative implications of this phase:

- Increases in per-piece costs resulting from declining volumes and fixed universal service obligations could necessitate service reductions and large rate increases if new revenue streams were not found. Among such service reductions could be closure of many small post offices and a reduction in the number of delivery days for residential customers.
- Volume diversion could result in “residual” mailers paying for the remaining fixed costs of the universal service infrastructure.
- Some stakeholders believe that none of the moderate reform changes are radical enough to respond to the market conditions that have already begun to transform the mailing industry.

Phase Three: Structural Transformation

There are a number of different ways in which fundamental legislative reform could be used to reconstruct the basic postal model. The Postal

Service might, for example, become more like a traditional government agency and less like a business, with an even stronger public service mandate and federal subsidies approved to meet the expanded public policy mission. Conversely, new legislation might further the transformation process begun in 1970, perhaps to include privatization as has occurred in the postal sectors in Germany, the Netherlands, and elsewhere around the world. A privatized Postal Service could include ownership

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by employees, the government, and the American public. Still other options may be suggested during the comment and analysis phase. Some observers have suggested that a restructured postal system could consist of a core monopoly service, possibly supported by appropriations and competitive private franchised services. These and other concepts will be analyzed.

Assumptions

There is much debate regarding the most effective method of ensuring universal service in an increasingly competitive postal marketplace. One possibility would entail the government contracting with the Postal Service and/or other organizations to provide retail and delivery services in unprofitable markets, should market-based prices in such areas threaten the universal service obligation. With this model of direct government compensation for the universal service obligation, the Postal Service's current monopoly might prove a hindrance, since some believe that monopoly protections require regulatory oversight. As a result, the monopoly protections and regulator constraints might be phased out, creating a level playing field in which the best service providers prevail in a competitive market.

With monopoly protections eliminated, the marketplace would ultimately define the product and service offerings. Service options would likely be more complex, sophisticated, and customized to narrower market segments.

Operations

The operational changes discussed in Phases One and Two would continue as the Postal Service implements cost control and productivity improvements. Operations would employ state of the art business practices (e.g., cost accounting systems, additional investment in automation, and increased flexibility in managing work hours and productivity) to make the Postal Service competitive in a private sector environment. Once the requirements of a new structure are defined, operations would be modified and enhanced to provide cost efficient new products and services demanded in the marketplace.

Finance

A privatized Post would raise its revenue through the sale of market-based competitive products and services. Shareholder fiduciary interests would determine standards of performance. The ability to raise capital would depend on the market's assessment of the Postal Service's business prospects. Factors such as the Postal Service's remaining or perceived link to the government, the presence of subordinated capital, the degree of liquidity within the balance sheet, existing leverage within the organization, and projected profitability would all factor into a credit rating for the organization and, in turn, the performance that shareholders would require. The Postal Service would

have broad investment discretion subject to the direction of its Board of Directors, like any other private entity.

In a privatization scenario, the financial objective of the Postal Service would be to maximize shareholder value. Financial strategies would contribute to that goal. In particular, like UPS's 1999 Initial Public Offering (IPO), the privatization itself would raise capital that could be invested in operational improvements and competitive ventures, and would allow the Postal Service to purchase other companies with its own stock. In this phase, the Postal Service might utilize its access to capital to underwrite new financial services to its customers, for example, extending credit terms to business mailers based on the value of their product in the mail stream. It might invest in companies that bring core competencies the organization needs to better serve its customers. It might also sell components of its infrastructure, for example some post offices, to companies that could improve the profitability of the operations.

Pricing

Pricing would be set in response to market forces, consistent with maximizing shareholder value, and subject only to laws and regulations of commercial entities (e.g., anti-trust). The Postal Service would set prices based on conditions in the market place (external conditions) rather than relying strictly on costs (internal considerations). Factors such as customer value, the competitive environment, and product and corporate strategy would play fundamental roles in pricing decisions, with cost being treated as a threshold factor. Pricing flexibility in this phase provides the Postal Service with myriad of pricing options, including:

- Price discrimination through dynamic pricing whereby prices are segmented based on different customers and changing market conditions (e.g., as practiced by the airline industry).
- Bundled pricing whereby Postal Service products are bundled to increase customer value. An example would be pricing catalog mailings together with the parcels those catalogs generate.
- Gain-sharing whereby the Postal Service's prices are partly determined by the impact of its services.

Human Capital

Corporatization and privatization would, some have argued, provide the Postal Service with needed flexibility to employ the right people in the right place at the right price. A "corporatized" postal service would have greater managerial freedoms that would permit the enterprise to function in the manner of private corporations. There would be greater freedom to adjust the workforce to meet volume changes and to address problem workers. Layoffs and other separation options could be used to trim the workforce commensurate with resource requirements. Training and development

would likely expand to meet the competitive requirements of a changing market. Investments in human capital would become increasingly critical to competitive success.

There would be no salary caps. The Postal Service would have the flexibility to offer numerous incentive options, including employee stock ownership plans and a variety of benefit option packages, which should improve the enterprise's ability to attract and retain talent. Pay for performance plans might be possible enterprise-wide. The Postal Service and the labor unions might be freed from binding arbitration to negotiate voluntary agreements that better balance business with employee needs. Some have suggested that the reforms that might be possible under a restructured Postal Service would give the unions the right to strike, in which case management would have to be prepared to sustain operations at the appropriate level.

Whether or not Phase Three would fundamentally alter the interest arbitration process is an open question. Some stakeholders have suggested that the current process with modifications could serve the institution well even in the event of market change. But there is no question that a restructured postal system would have to have greater flexibility to adjust to changing markets. The size and the skills of the current workforce will have to change over time as is the case in private enterprises throughout the economy. As volume changes require adjustment in the numbers of employees and in the mix of skills, the question of how to protect employee rights while increasing the capacity of the organization to respond to market pressures will become a rising priority.

Phase Three Implications

There are some notable strengths related to this option, which were apparent in the discussions with stakeholders:

- Market discipline would drive increased efficiency.
- The Postal Service would continue as a competitive employer, even in a rapidly changing market.
- The new enterprise would be freed from most regulation and oversight and become subject to commercial laws.
- Customers might benefit from competition in a deregulated postal marketplace.

The following are possible negative implications of this phase:

- Universal service would be more difficult to maintain.
- Prices could increase substantially for high cost areas if uniform rate restrictions were abolished.
- There would likely be significant pressure on above-market wage rates.

Section 7: Stakeholder Input

To build a partnership with Postal Service stakeholders in the development of the Transformation Plan, the Postal Service has adopted a multi-step approach to gaining stakeholder input. Step One has included informal meetings and discussions with postal stakeholders: employees, mailers, suppliers and policy makers. Input from others beyond these informal meetings will be sought in Step Two, following the publication of the *Outline for Discussion*. In Step Two, the *Outline for Discussion* will be widely distributed for comment. A more detailed discussion of Step Two may be found in Section 8: Next Steps.

During Step One, the Postal Service held twelve meetings with representatives from employee, mailer, supplier and policy maker groups to ensure that the phases discussed in the previous section covered the range of issues necessary in a Comprehensive Transformation Plan. These meetings were beneficial in the development of this *Outline for Discussion*. There have also been ongoing discussions with the General Accounting Office. Sessions were held with the staff of the Senate Governmental Affairs Committee and its Subcommittee on International Security, Proliferation and Federal Services and with the staff of the House Committee on Government Reform. In addition, meetings were held with members and staff of the Postal Rate Commission and with representatives from postal unions, three management associations, members of the Main Street Coalition, and the Coalition to Preserve Universal Mail Service. Numerous discussions were also held with mailers and the associations that represent them. A meeting was held with one of the Postal Service's key partners and suppliers.

A number of key themes emerged from the meetings:

- Most participants noted the current critical financial situation facing the Postal Service. There was no general agreement on whether the current situation would follow the historical pattern and reverse when the economy recovered. Nor was there agreement on whether the current financial situation is the beginning of a downward trend stimulated by the technology revolution and economic downturn. Of those who felt it was the beginning of a downturn, there was no consensus on how to solve the problem. Suggestions ranged from "sun-setting" the Postal Service, to focusing on various approaches to achieving moderate legislative reform, to complete privatization into a stock company with public shares sold to the public.
- Increasing prices were a key concern of almost all parties. Customers who perceive that they have no feasible alternatives to the mailing system are particularly concerned with rising prices.

- While some seemed to feel that mail volume would rebound with an improving economy, most felt that the Internet and globalization have changed the future of hard copy delivery and that the Postal Service faces potential acute, long-term revenue problems.
- Stakeholders were evenly split on the extent to which the Postal Service should limit its focus to letters, flats, and parcels. There was no agreement on a definition of the Postal Service's core products.
- There was no agreement on whether the universal service obligation should be left as a general statement or redefined to narrow its boundaries.
- Stakeholders who felt most closely tied to postal products worried about the cost of being left in the system and having to cover major cost increases as others might leave.
- There was general support for management efforts to improve productivity and cut costs, but there was concern with future workforce costs and competition from other international and domestic companies.
- Finally, there was general concurrence with the basic approach for the development of the *Outline for Discussion*.

So far there is no clear consensus among stakeholders about the vision of the future postal service. In the case of the transformation phase that relates to fundamental structural reform, the stakeholders noted many issues that will require discussion with Congress: the definition of universal service; discomfort with competitive service offerings; concern with long-term, personnel-related costs; facilities utilization; and, the optimization of the postal network.

Section 8: Next Steps in Stakeholder Input

The publication of this document marks the end of Step One of the stakeholder outreach effort. Step Two calls for the following actions to be taken to reach representatives in each of the five general stakeholder audiences: employees, mailers, consumers, suppliers and policy makers.

This *Outline for Discussion* will be published on the Postal Service's Strategic Direction web site at www.usps.com/strategicdirection. Organizations representing employees and mailers will be contacted and asked to comment using a special email address. Policy makers, the Postal Rate Commission, postal suppliers, individual mailers, national accounts, those who intervened in the last rate case, members of the Postal Service Supplier Quality Council, the Mailers' Technical Advisory Committee, the Mail Industry Task Force and the Marketing Advisory Board will also be contacted, directed to the web site, and asked to comment using the specially designated email address. Comments will be tracked, categorized, analyzed and relied on in the preparation of the Comprehensive Transformation Plan.

To reach as many stakeholders as possible, a special notice will be placed in the *Federal Register* directing interested parties to the Strategic Direction web site so that they may comment electronically on the transformation effort and this *Outline for Discussion*. Interested persons may write directly to the Postal Service during the public comment period that will last until November 1, 2001. All comments should be emailed to: transformation@email.usps.gov or mailed to Julie S. Moore, Executive Director, Office of Transformation, Strategic Planning, Room 4011, U.S. Postal Service Headquarters, 475 L'Enfant Plaza, SW, Washington, DC 20260-1520.

To obtain further input from consumers and businesses, focus groups will be conducted. A review of past consumer surveys on postal issues will be made to find relevant information. Through publication in internal communication channels, postal employees will be updated on the development of the Transformation Plan and asked for input. The opinions of postal executives will be solicited at the annual National Executive Conference October 22–24, 2001 and via a post-conference survey on the Strategic Direction web site. Employees identified as future Postal Service leaders will also be contacted.

Additional stakeholder meetings will be held during October and early November. Several meetings, including one with the Steering Committee of the Mailers' Technical Advisory Committee (MTAC) will be held at the fall National Postal Forum, a trade convention held in Denver, CO. in late October. In November, a briefing will be given to the general MTAC membership.

Transformation Office

The Postmaster General has made the Transformation project one of his highest priorities. The vice presidents and senior executives selected by the Postmaster General to undertake the preparation of the Transformation Plan will serve on a Steering Committee that will guide this effort

and continue to coordinate stakeholder input and internal analysis of the transformation phases. Experts and specialists from throughout the agency will develop strategies and analyze the impact of proposed changes. As needed, specialists from other government agencies and from the private sector will also be contacted and asked to focus on and address postal transformation. Executives of the Postal Service will continue to meet regularly with policy makers to apprise them of the ongoing process and to receive their feedback prior to publication of the Transformation Plan at the end of the year.

Section 9: Conclusion

The Postmaster General has labeled the Transformation Plan a “living document.” This *Outline for Discussion* is the first step in what is expected to be an ongoing process of interaction and public policy debate. This process is intended to grant the policy makers the opportunity to make informed decisions about the future of the Postal Service.

To best serve the needs of the American people and the American economy in the 21st century, what should America’s postal system be like (or transform to) in the next decade? As the process proceeds, this core question, as well as the questions that follow, will need to be addressed.

- **Should that system provide “universal service” and what should that entail?**

Traditional concepts of universal service in the United States have included a number of characteristics including delivery scope and delivery standards, access to post offices, uniform pricing, product offerings and security services. Should all of these features continue to be a part of postal services? For example, should the Postal Service deliver to every neighborhood every day? Should delivery frequency be reduced for low mail volume neighborhoods? Should the scope of the retail service to nearly 40,000 outlets continue? Should alternative delivery methods be encouraged?

- **What should the “core” services of the future postal service be?**

Some observers such as the Comptroller General have challenged the Postal Service to define its core service more rigorously. What comparative advantages does the publicly owned Postal Service (versus other providers) bring to the mailing industry? What services should be left to the marketplace and to private competitors and what services should be provided by the national postal system?

- **How should the nation structure a future postal system to be as productive and efficient as possible and to ensure that consumers pay only what they wish to pay, for as much service as they can afford?**

The design of the operations of the future postal network has many variables. Often improvement in productivity and efficiency through cost cutting can come at a cost to improved service. Which values are most important? Should maintenance of affordable pricing be more important than improving service? Or the reverse? What level of productivity and efficiency will guarantee that the cost of postal services is low but that service remains high? Should there be more rigorous automation standards as there are in other countries? What should the characteristics of the future postal operations network be?

- **Can the Postal Service continue to provide universal service under the current financial arrangements if volume slows or declines significantly? Are there other financing mechanisms needed?**

The critical threat to the current economic model is thought by many observers to be connected to volume decline. How should the Postal Service seek to finance its operations in the event that volume does decline? Should the future Postal Service seek support through the appropriations of tax revenues? Should universal service be narrowed? Are there other financing mechanisms that should be explored even without potential volume declines? Should the Postal Service be granted more freedom in financing investments?

- **What steps should be taken today to anticipate the human capital requirements of the future postal system in a manner that embodies core values of respect, dignity and diversity while providing incentives to encourage continuous service improvement?**

How should the balance be struck between individual values and improving the efficiency of the postal system? Is there a trade-off today? What investments should be made in attracting, training, managing, and providing incentives to people to build the future postal system? Should incentives be tied to performance throughout the postal system? Is the collective bargaining process, as it is structured today, going to serve the needs of the future Postal Service? Should salary caps be removed? Where should the priorities be?

- **Is it possible to design a government postal system in the United States that operates more commercially and still serves important social objectives including universal coverage?**

How might the Postal Service offer competitive products? If the private sector is offering similar services, should the publicly owned postal service enter markets where it would compete with the private providers? There are both advantages and disadvantages for the public agency in

offering services in competitive markets. Is the playing field uneven in favor of the public or private sector service provider?

- **How would a privately owned postal entity or entities perform against public expectations for postal services? Are there other models that may do a better job for the American people?**

A number of key postal policy voices in recent years have called for the privatization of the Postal Service. Is this desirable? Would a corporatized postal service be able to be more productive? To provide better service? To grow the mailing business for the postal industry? Or are there other models of fundamental structural reform that should be considered? Should the postal system be franchised out to private sector providers? Should fundamental structural reform retain the continuity of the end-to-end infrastructure that exists today?

As mentioned in the previous section, all comments should be sent by email to: transformation@email.usps.gov or mailed to Julie S. Moore, Executive Director, Office of Transformation, Strategic Planning, Room 4011, U.S. Postal Service Headquarters, 475 L'Enfant Plaza, SW, Washington, DC 20260-1520

Informal discussions with stakeholders and policy makers have reconfirmed that there is a lack of policy consensus about the answers to these questions and others. There may not be a need for all stakeholders to agree on every question. But it is to be expected that there may need to be a process of public policy discussion before issues can be resolved and a widely accepted Comprehensive Transformation Plan can be crafted. The purpose of this *Outline for Discussion* is to facilitate this process.