IMPLEMENTATION OF THE POSTAL ACCOUNTABILITY ENHANCEMENT ACT OF 2006

HEARING

BEFORE THE

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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IMPLEMENTATION OF THE POSTAL ACCOUNTABILITY ENHANCEMENT ACT OF 2006

THURSDAY, FEBRUARY 28, 2008

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 4:21 p.m., in room 2154, Rayburn House Office Building, Hon. Danny K. Davis (chairman of the subcommittee) presiding.

Present: Representatives Davis of Illinois and Norton.

Also present: Representative Waxman.

Staff present: Lori Hayman, counsel; William Miles, professional staff member; LaKeshia Myers, clerk; Ed Puccerella, Alex Cooper, and Chris Espinoza, minority professional staff members.

Mr. DAVIS OF ILLINOIS. The subcommittee will come to order. Welcome members of the subcommittee, witnesses and all of those in attendance.

Welcome to the Federal Workforce, Postal Service, and the District of Columbia Subcommittee hearing on the Implementation of the Postal Accountability Enhancement Act of 2006. The purpose of this hearing is to examine how the U.S. Postal Service, the Postal Board of Governors and the Postal Regulatory Commission are implementing the act and its impact on the postal community. Hearing no objection, the chairman, ranking member and subcommittee members will each have 5 minutes to make opening statements, and all Members will have 3 days to submit statements for the record.

Ranking Member Marchant, members of the subcommittee and hearing witnesses, welcome to the subcommittee's hearing on the Implementation of the Postal Accountability Enhancement Act of 2006. Today's hearing will examine the progress of the U.S. Postal Service and the Postal Regulatory Commission and the implementation of the Postal Accountability Enhancement Act of 2006.

The Postal Service performs a valuable national service. In 2007, it delivered over 212 billion pieces of mail to nearly 148 million delivery points. Over $80 billion was spent in providing these and other Postal Services required as part of meeting the Postal Service's universal mandate. To ensure the financial soundness of the service and its primary function of mail delivery, the Congress passed the Postal Accountability and Enhancement Act of 2006. The act, making it the first major piece of postal reform legislation since the one that created the Postal Service in 1970.

The act was a direct result of the postal community coming together and reaching agreement on work sharing, rate setting, price and flexibility, diversity and a number of other provisions to ensure that the Postal Service can compete in today's marketplace. It is only through an economically vibrant Postal Service, one that can respond rapidly and effectively to changing markets and conditions, that we can preserve the important American ideal of universal service. To ensure compliance with the act, the subcommittee has conducted and will continue to conduct aggressive postal oversight and in particular, monitor the implementation of the Postal Accountability and Enhancement Act of 2006.

Today, I look forward to hearing about the progress the Postal Service and the Postal Regulatory Commission have made in implementing the changes mandated in the act. We have already seen evidence of progress. For example, the Postal Regulatory Commission developed and issued final regulations for a new ratemaking system on October 29, 2007, nearly 8 months before the statutory deadline of June 20, 2008, set forth by the act. On February 11, 2008, the Postal Regulatory Commission filed for its first-ever rate adjustment for market dominant products under the new regulations when they announced that the price of a first-class stamp will increase by 1 cent effective May 12, 2008.

I thank you and look forward to hearing testimony from today's witnesses. We will now hear testimony from the witnesses before us.

Our witness for panel one is Professor Frank A. Wolak, he is a professor of economics at Stanford University. His fields of research are industrial organization and empirical economic analysis. Dr. Wolak specialized in the study of privatization, competition and regulation and network industries such as electricity, telecommunications, water supply, natural gas and postal delivery services. He assisted the Postal Rate Commission with numerous rate cases and regulatory issues for more than 10 years and has written numerous academic articles on postal economics. Thank you very much, Professor Wolak. And as customary, witnesses before this committee are sworn in.

[Witness sworn.]

Mr. DAVIS. The record will show that the witness answered in the affirmative. Again, let me thank you so much. And we will proceed. Your entire statement will be included in the record. We would like for you to take 5 minutes and summarize that. Of course we have a timer. And when things get yellow, it means that you are down to 4 minutes. And then as they turn red, we would like for you to kind of wrap up. And thank you so much.

STATEMENT OF FRANK WOLAK, PROFESSOR, DEPARTMENT OF ECONOMICS, STANFORD UNIVERSITY

Mr. WOLAK. Thank you, Mr. Chairman, and thank you for the opportunity to contribute to this hearing. I will focus my results on what I believe to be the crucial aspect of the successful implementation of the modern system of regulation, which is a goal of the Postal Accountability Enhancement Act and that is the data collection analysis and dissemination of data by the Postal Regulatory Commission. So a modern system of regulation that attempts to

balance two competing goals, strong incentives for the firm to produce in a least-cost manner and to protect consumers from prices for market-dominant products that reflect the market power of the monopoly provider.

And the price cap mechanism is one such approach that is attempting to cheat both these goals. And this is certainly a—one of the things, and it is a part of the process, but I believe that a major role that can really make this process work even better is if the Postal Regulatory Commission fully exploits its information gathering powers under the act to attain the best possible data from the Postal Service that is appropriate for its needs and uses this data to analyze postal operations, compute accurate product level cost estimates, construct service quality entities and all of these can significantly increase the likelihood that the act will actually achieve the goals of maintaining higher service quality levels and setting economically efficient pricing.

Another role for the Commission under the act is to quantify the cost of the universal service obligation. And this is a conceptually challenging task that requires intimate knowledge of Postal Service operations. And once again, the ability of the Postal Rate Commission to—Regulatory Commission—excuse me—to gather data, to analyze cost is an important aspect of determining the universal service obligation.

And to make sure that informed decisions can be made about what it should look like and how it should adapt to the changing competitive conditions that the Postal Service faces. I would now like to discuss just a bit in terms of the role of the information provision. What information provision can really do in a regulatory process is provide what I would like to call smart sunshine regulations. And by this I mean the collection of data and analysis in a manner and release to the public in a manner that really helps parties on an ongoing basis monitor the performance of the Postal Service over time as well as across processing locations to improve the effectiveness of the postal regulatory process and the effectiveness of Postal Service operations.

Another area where this ability to gather data can be particularly important is that in previous rate cases, the Postal Rate Commission in its previous inter carnation has identified significant errors in data used by the Postal Service in a number of their mail processing studies. And if the Postal Regulatory Commission is able to request data that it needs and ensure that it is suitable for the task, it can therefore improve the process of cost studies as well as improve the accuracy of pricing and other sorts of things.

A final but important benefit of the Commission's regulatory authority is just simply monitoring—the overall monitoring of the health of the Postal Service, similar to a doctor taking a patient's temperature, pulse and blood pressure and other measures of health status. And in the same way that a patient's vital signs are used by a doctor to diagnose an illness and recommend a remedy, changes in these performance—a consistent set of performance measures collected over time can be used by the Postal Regulatory Commission in the same way that the doctor uses these vital signs to diagnose problems, to be proactive and in recommending any

sort of cures for problems discovered before they develop into significant problems.

The final point that I would like to discuss is the question of the need for a proactive data collection and analysis rather than a retroactive. And in particular, the act calls for the Postal Service to notify the Commission of any intention to raise rates. And allows for a retrospective review of these rates if the Postal Regulatory Commission receives comments from the party on these rates. The difficulty is is that the timing of this process is such that by the time the process actually occurs and the rates are reviewed, it would be extremely difficult to actually implement the rates that are finally reviewed in time for the next submission by the Postal Service for a rate increase in a future period.

So this really emphasizes the importance of a proactive process of collecting data, analyzing data, being ready and immediately available to act in response to a Postal Service rate proposal with the state-of-the-art cost estimates.

So in conclusion, I just would like to say that I think the Postal Accountability Act can really achieve the goals that is intended but an important part of achieving those goals is the authority of the Postal Regulatory Commission to obtain the best possible information and use this in a proactive manner to inform both its process as well as the public debate over the future of the Postal Service. So thank you very much for the opportunity to speak. And I look forward to your questions.

[The prepared statement of Mr. Wolak follows:]

Implementing a Modern System of Regulation for the Postal Service under the Postal Accountability and Enhancement Act

by

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Draft: February 25, 2008

1. Introduction

The Postal Accountability and Enhancement Act (Postal Reform Act) proposes to implement a modern system of regulation for the Postal Service that controls the price of both market dominant products and competitive products, yet still allows the Postal Service an opportunity to recover its total production costs through the sale of these products. In order to streamline the regulatory price-setting process, the Postal Reform Act also allows the Postal Service greater flexibility in pricing individual products and offering new products.

A modern system of regulation attempts to balance two competing goals: (1) providing strong incentives for the regulated firm to produce its output in a least-cost manner, and (2) protecting consumers from excessive prices for postal services that reflect the exercise of monopoly power by the Postal Service. The cap on total annual price increases in the Postal Reform Act is designed to achieve both of these goals. The maximum annual increase in price limits the amount that the Postal Service can increase prices each year. Price cap mechanisms that restrict the maximum percentage price increase that the regulated firm can implement over last year's price using the Consumer Price Index (CPI) provide strong incentives for a privately-owned regulated firm to produce in a least-cost manner. The firm's output price and therefore its revenues are largely independent of its own actions, so the only firm-level actions that can increase its profits are those that reduce total production costs.

Consequently, if the Postal Service was a privately-owned profit-maximizing firm, its desire to maximize profits would provide strong incentives for it to produce in a least-cost manner. However, government ownership of the Postal Service makes it extremely difficult for the price-cap regulatory mechanism in the Postal Reform Act to provide incentives for least-

cost production. Unless the Postal Regulatory Commission fully exploits the subpoena power of the Postal Reform Act to request accurate and appropriate data from the Postal Service and uses this information to perform prospective reviews of proposed rate increases, it will be very difficult, if not impossible, for the Postal Regulatory Commission to achieve the pricing the goals of the Postal Reform Act. Finally, the Postal Service's universal service obligation further complicates achieving the goals of least-cost production and efficient pricing.

The purpose of my testimony is to explain the challenges faced by the Postal Regulatory Commission in implementing a modern system of regulation. I then describe what actions the Postal Regulatory Commission can take within the mandate of the Postal Reform Act to balance the two competing goals of a modern system of regulation. I then describe the challenges in defining and satisfying the Postal Service's universal service obligation and still achieve the goal of a modern system of regulation. Finally, I describe why pro-active collection and analysis of accurate and appropriate postal operations and cost data is essential to an effective regulatory process under the framework specified by the Postal Reform Act.

Implications of Government Ownership of the USPS

Regulatory mechanisms that provide strong incentives for least-cost production typically rely on the existence of a residual claimant that can exercise control over the firm's management. For privately-owned firms, shareholders are the residual claimants for any revenues greater the sum of the firm's variable costs of production and debt obligations. The combination of the firm's owners demanding the highest possible return on their investment and a price cap mechanism which sets the maximum output price the firm can charge, yields very high-powered incentives for the firm to reduce its production costs.

A government-owned firm, such as the Postal Service, does not have a residual claimant with the ability to provide the firm's management with incentives to achieve the highest possible return on investment. Different from a privately-owned firm, there are no mechanisms for the citizens of the United States to sell their ownership stake in the Postal Service or replace its managers if they are unhappy with how the Postal Service is being operated.

The lack of a residual claimant also makes it extremely difficult for the Postal Regulatory Commission to reduce the revenues that the Postal Service is allowed to earn if it believes that the Postal Service is not being managed in an efficient manner. In contrast, for privately-owned firms, the regulator has the option to reduce the firm's allowed revenues, which reduces the return received by the firm's shareholders. The risk of a reduced return on investment for the firm's shareholders provides strong incentives for the firm's management to produce in a least-cost manner. If the shareholders do not receive an adequate return they can replace the firm's management or sell their ownership stake in the firm, which makes it more costly for the firm's managers to raise money for any new investments.

The Postal Service is also severely limited, relative to a privately-owned firm, in its ability to provide financial incentives for its managers to take actions to maximize operating profits. Shareholders of private firms often offer substantial bonuses to management and the threat of a job loss to align the incentives of the management with their desires as the firm's residual claimant. Under the Postal Reform Act, the Postal Service is limited in its ability to reward and punish management for the performance of the Postal Service.

Consequently, the price cap mechanism in the Postal Reform Act is unlikely to cause Postal Service to produce in a least-cost manner. At best, this mechanism protects consumers

from excessive prices for both market dominant and competitive products. However, if there are opportunities for cost reductions or total factor productivity growth improvements known only to the Postal Service, the price cap mechanism in the Postal Reform Act may allow the Postal Service to set prices higher than those necessary to recover its production costs with these cost reductions factored in. This risk of setting prices that are too high is particularly great during the initial stages of the implementation of the price cap mechanism because there may be one-time opportunities for cost reductions and productivity improvements, the benefits of which will not be passed on to postal consumers, because the ownership structure of the Postal Service results in its management having little incentive to realize them.

Role of Information Provision in Effective Regulation

As the above discussion demonstrates, the price cap mechanism alone is unlikely to allow the Postal Regulatory Commission to achieve the twin goals of a modern regulatory process--least cost production, and no exploitation of monopoly pricing power. Fortunately, there are other features of the Postal Reform Act that can be used to achieve these goals. The most important is the subpoena power of the Postal Regulatory Commission to request information from the Postal Service. Others include the requirement for the Postal Service to submit detailed annual reports to the Postal Regulatory Commission and provide it with access to any working papers and any other supporting matter used to prepare these annual reports.

Use of this subpoena power by the Postal Regulatory Commission to obtain data on the financial health and operating efficiency of the Postal Service is crucial to providing strong incentives for least-cost production by the Postal Service and protecting consumers from prices

that cross-subsidize competitive products or are in excess of those necessary to recover the Postal Service's production costs.

The Postal Regulatory Commission can use information about postal operations that it obtains to provide "smart sunshine regulation" of the Postal Service. I define "smart sunshine regulation" as the collection and analysis of detailed information on postal services operations and production costs in a manner that allows the Postal Regulatory Commission, major postal consumers, and other interested parties to monitor on an ongoing basis the performance of the Postal Service over time and across postal processing locations to improve the effectiveness of all aspects of the postal regulatory process.

An important role of the Postal Regulatory Commission is to ensure that market-dominant postal products are not cross-subsidizing other postal products. This requires determining the volume-variable costs and product-specific fixed costs associated with all Postal Service products and then verifying that the price charged for each of these products exceeds its average incremental cost (the sum of the volume variable costs and product specific fixed costs divided by the number of units of this product produced). An essential input into the process of computing these product specific costs is highly accurate, detailed data on postal operations. In previous rate cases, the Postal Rate Commission has identified significant errors in several of the data sources used by the Postal Service in their mail processing cost studies.

Having the ability to subpoena information from the Postal Service would allow the Postal Regulatory Commission to gain a better understanding of both the magnitude and causes of these data quality issues. Postal Regulatory Commission could obtain the raw data underlying the data used in the cost studies or request information from other Postal Service

sources that could shed light on these data errors and ultimately improve the accuracy of the operations and cost data provided by the Postal Service.

Accurate operations and cost data from the Postal Service is an essential for the Postal Regulatory Commission to carry out a number of its other duties under the Postal Reform Act. Detailed and accurate cost information is also necessary to determine the contribution each product makes to recovery of the Postal Service's common costs. The Postal Reform Act requires the Postal Regulatory Commission to monitor the actual contribution of competitive versus market dominant products and determine the appropriate level for this contribution on an ongoing basis.

The Postal Service is also required to pay taxes on the income it earns from sales of competitive products. Assigning fixed-costs and volume-variable costs to competitive and market-dominant products is a key step in determining the Postal Service's tax liability. Accurate and appropriate cost data is essential to this task.

To fulfill its statutory mandate, the Postal Regulatory Commission must be confident that all of the above-mentioned calculations are being performed with the most accurate operations and cost data available. It can only be sure of this if it has access to the raw data and the sampling schemes used to compile this data. The Postal Regulatory Commission can be assured of receiving this information only if it has the ability to subpoena it from the Postal Service.

As noted earlier, a key feature of a modern regulatory process is to provide strong incentives for the firm to produce in a least-cost manner. The Postal Regulatory Commission can use its ability to gain access to Postal Service data to perform productivity studies and

benchmarking studies. For example, the Postal Service performs a number of identical mail processing operations using almost identical technology at different geographical locations across the United States. The Postal Service's data, however, show that the productivity of those operations varies widely across locations. Quantifying the magnitude, and identifying the causes of these wide productivity differences across processing plant locations can provide valuable input to Postal Service to improve it overall productive efficiency and reduce its total production costs.

A final, but very important, regulatory benefit of the Postal Regulatory Commission having the ability to issue subpoenas to the Postal Service is the fact that the Commission can use this information to prepare and disseminate reports on the performance of the Postal Service that provide guidance for improving the efficiency of postal operations. These analyses could be released to the public in a form that would not compromise the Postal Service's ability to compete, but it would provide key performance measures that large postal consumers and government oversight agencies can monitor to gauge the extent to which the Postal Service is producing in a least-cost manner and not setting prices that cross-subsidize certain Postal Service products.

This extensive data collection and analysis effort by the Postal Regulatory Commission can also allow it to make more informed decisions about the need for postal rate increases proposed by the Postal Service under the price cap mechanism. The Postal Reform Act gives the Postal Regulatory Commission the duty to perform an ex ante review of a proposed postal rate increase under a tight deadline, as well as the ex post review described above. If the Postal Regulation Commission has compiled and analyzed all relevant operations and costs data on an

ongoing basis this will allow the best possible ex ante assessment of the benefits and costs of postal rate increases proposed by the USPS during the initial ex ante review period. This sort of information would be very valuable to Postal Regulatory Commission in preparing an initial response to the recently announced Postal Service price increases.

Because financial incentives cannot be used in the same manner as in the private sector, the Postal Regulatory Commission can make use of "smart sunshine regulation" to provide incentives for efficient postal operations and improved estimates of product-specific costs that are essential to a number of the Postal Regulatory Commission's duties under the Postal Reform Act. Using its ability to gain access to and analyze data on postal operations can shine the light of public scrutiny on inefficient postal operations or actions that raise the prices postal consumers must pay with no corresponding public benefit. Using this mechanism, the Postal Reform Commission can provide strong incentive for least-cost production by the Postal Service and ensure that Postal Service prices only recover these production costs.

Operations Data and the Universal Service Obligation

Another duty of the Postal Regulatory Commission under the Postal Reform Act is to determine as precisely as possible the cost of the Universal Service Obligation (USO). This is an extremely challenging economic modeling task. The cost of Postal Service operations must be estimated with and without the USO imposed. This requires intimate knowledge of postal operations and the factors determining postal costs. Having the ability to request and receive information from the Postal Service will allow the Postal Regulatory Commission to produce the best possible estimate of this magnitude.

The Postal Regulatory Commission must also propose revisions to what constitutes the USO. This will require measuring the costs versus benefits of actual and proposed features of the USO, which will also require even more intimate knowledge of postal operations and how Postal Services costs are determined.

By making USO costs as transparent as possible to postal consumers and the public at large more informed decisions can be made about precisely what the USO should be. The rapid growth of competitors to the products and services provided by the Postal Service implies that the benefits of informed decisions about all dimensions of the USO could yield significant benefits to postal consumers.

Effectiveness of Commission Review of Non-Rate Cap Issues

A weakness in the regulatory scheme established by the Postal Reform Act could arise if the Postal Regulatory Commission were to decide not to examine issues other than rate-cap compliance at the time that the Postal Service proposes new rates. If the Commission were to rely almost exclusively on after-the-fact scrutiny of such issues, it is difficult to see how such scrutiny could be effective.

For example, the Postal Service could propose to implement rates that satisfy the cap for a particular class as a whole. For some products within the class, however, it could propose rates that are non-compensatory, or propose discounts that are greater than the savings they are supposed to reflect. I understand that there examples of both in the rates that the Postal Service proposed last week. [It appears that the rates proposed for Standard parcels and some components of Parcel Post do not cover their costs as measured by the Postal Regulatory

Commission. It also appears that discounts for several tiers of First-Class presort discounts exceed the costs that they avoid as measured by the Postal Regulatory Commission.]

If the Postal Regulatory Commission defers analysis of these aspects of new rates until after they are implemented, and addresses them only after a complaint is filed or its annual compliance report is issued, it is unlikely that the Postal Regulatory Commission can fashion a meaningful remedy. Scrutiny in the context of a complaint or of the annual compliance report is likely to take several months to complete if input from the various stakeholders is to be solicited and adequately taken into account. Any rate revision that the Commission might order would take several additional months of software preparation by private industry before it could be implemented. Consequently, it is doubtful that any correction that the Commission might order could be implemented for more than a month or two before the Postal Service files a new round of rate increases. If corrected rates are unlikely to ever be in effect for more than a month or two, the Commission is unlikely to order them.

The solution to this dilemma is for the Commission to undertake a meaningful analysis of non-rate-cap issues before rates proposed by the Postal Service go into effect. The above logic demonstrates the crucial importance to effective regulatory oversight of the Postal Service of a pro-active data collection and analysis effort by the Postal Regulatory Commission of all aspect of Postal Services operations. A key goal of this process is to ensure that the Postal Regulatory Commission has the most accurate and appropriate data available to carry out its statutory obligations.

Concluding Comments

The Postal Accountability and Enhancement Act provides an opportunity to implement a regulatory process for the Postal Service that increases the efficiency of postal operations, produces the best possible estimates of product-specific costs to ensure that are no cross-subsidies in the pricing of postal products and that competitive products make an appropriate contribution to the recovery of the common costs of Postal Service operations, limits postal prices increases to only those necessary recover total Postal Service costs, and produces the transparent estimates of the current and future costs of the universal service obligation.

These goals can only be accomplished if the Postal Regulatory Commission has ability to obtain the best possible information about postal operations and can pro-actively use this information in its decision-making process and to prepare reports that it makes available to the public. As discussed above, the usual capital market discipline and competitive pressure that provides strong incentives for efficient operation and prices that only recover efficiently incurred production costs cannot operate for the Postal Service because it has a government-owned statutory monopoly over most postal delivery services. The oversight of the Postal Regulation Commission and its ability to issue subpoenas and require periodic reports by the Postal Service can be used to provide these incentives for efficient operation and prices that only recover production costs.

Mr. DAVIS OF ILLINOIS. Thank you very much, Dr. Wolak. Again, let me thank you for coming and for being here.

As you know, total mail volume is declining. That is both first class and standard mail. My question is this: Do you think that these trends are going to continue? And if they are, is there anything that the Postal Service can do? Or can you think of the Postal Service doing anything that might turn these trends around?

Mr. WOLAK. Well, I think it's—there are certainly in my own research, I've identified trends in the—certainly the decline in the household for postal delivery services. And it certainly seems that on the business side with people receiving their bills online as well as paying online, this is certainly going to lead to a business decline. But I think the opportunity that the act really allows is the ability of the Postal Service to, if you like, use its pricing flexibility to maximize the amount of revenue it can receive from a given class of mail by the flexibility that it has to alter the prices.

So this would call—say that it gets back to again the issue of data collection, of it would be useful for the Postal Service to really get a much better idea of what the structure of its demand looks like as well as what the structure of the cost it looks like because typically firms in the, you know, private sector competitive sector, the way that you maximize their contribution to fixed cost that you achieve is by knowing the variable cost of each product that you sell and understanding the structure of demand for your product.

So I think that there is a role for much greater data collection and value of data collection analysis also by the Postal Service as a way to if you'll like, make the most for the volume that it actually serves. You know, sort of the decline in volume is, in some ways, I think, is a function of the changing nature of the way that we communicate. And it's sort of not something we can do a whole lot about.

Mr. DAVIS OF ILLINOIS. Well, let me ask you, as an expert in regulating the energy and telecommunications industries, what lessons have been learned there that might be applicable or applied to trying to regulate as effectively as possible the postal industry?

Mr. WOLAK. Well, I think that was the major theme of my testimony is to really try to bring those lessons and the important lesson that I've learned from certainly my experience with electricity is you know get the data out there, allow people to analyze it, to understand it. You know, many eyes looking at information, looking at how things are working can provide far better regulatory oversight than a very insular and closed process. The other is, I think, getting the information out there can help to make some pretty politically difficult decisions to move forward, to make the, you know, Postal Service financially viable into the future by informing the process with good analysis. I guess the way that I would characterize it is is having the data and performing analysis constrains the amount that people can theorize without any basis.

And therefore, reduces the amount of, if you like, you know, idle talk and focuses in on what really is the sort of the tradeoffs that must be faced in moving forward because you can say, this bit of analysis rules out that as a possible explanation. Let's really get down to what is consistent with the work that we've done. So I think it's really the quantitative—gathering the data, analyzing the

data and, you know, putting it into the public discussion is, I think, very useful.

Mr. DAVIS OF ILLINOIS. Accurately forecasting or trying to know and project what the volume of mail is going to be is obviously essential to the Postal Service in order for it to plan well. How well do you think the Postal Service is doing in both its short-term planning as well as long term?

Mr. WOLAK. I think it's an extremely difficult task. I guess the thing that I would emphasize is that it may be worth spending some money to engage in what most businesses do, which is essentially marketing research in the sense of, who are my customers, how much they spend, why do they spend what they spend, and analyzing you know that kind of information. I know that the Postal Service collects what's called consumer diary survey, which is a diary of essentially households. But there's not a similar survey for the business sector, which is certainly, I think, a very rapidly changing sector in terms of the types of postal products that its using.

So having say an ongoing probability sample of those sorts of customers, to understand why they're moving where they're moving I think can really help the Postal Service get a much better handle on where their volume is going. I think—you know, currently, I guess what I'd say is given the data that they do collect, I'd say they do a very good job. But I think getting a bit more into you know customer level surveys that are representative of the class of customers that you face in truly trying to understand the trends for specific customers and drivers for specific customers I think can really help to improve those sorts of forecasts.

Mr. DAVIS OF ILLINOIS. Almost every month it appears as though there's some additional electronic diversion of possibility relative to technology just simply burgeoning, and it seems unlimited. Do you have any forecast or projections as to whether or not we're going to continue to see an increase in electronic communication? Or is there going to be any leveling off so that we might continue to have the same level of need that exists for the mail delivery that we see coming from the Postal Service?

Mr. WOLAK. Well, certainly in the work that I've done at least for the household sector, which is all I've managed to have the data for. I'm hoping the Postal Service will collect from the business sector to analyze that. But for the household sector, it certainly seems that the good news is is everybody has high speed Internet access and essentially there therefore is sort of a leveling off in terms of the impact of the growing penetration of electronic communication.

So in that sense I think there is evidence at least for that it's leveling off. If you like sort of the major—it seems electronic diversion from the household sector occurred probably about when the Internet was really ramping up. But now almost everyone who is using the Internet is using the Internet. And, but the unfortunate thing is that the sort of intensive users of the Postal Service and probably the most in-elastic demanders at the Postal Service at the household level are certainly—unfortunately the older people. And they're sort of—they're going away. And the less intensive users and more flexible users are growing. So you know, that's another factor that I think is unfortunately contributing.

Mr. DAVIS OF ILLINOIS. Thank you very much. Representative Norton.

Ms. NORTON. Mr. Chairman, as you may remember, I'm fascinated by this model that at least in this country, that I see is unique. And I appreciate very much Mr. Wolak's testimony and particularly when it began by looking at how private sector firms would operate, and then moving on to what tools might help the Postal Service. I'm really—particularly after sitting through hearings and being struck by conundrum after conundrum in what is being required of the Postal Service. I begin to wonder about this model itself.

I notice you talked about vital signs. Well, you know, vital signs assumed the organs that are in this body belong in this body and are supposed to work together. So you know, you get sick and you put some medicine in it and they begin to work like they're supposed to work. But what you've got here is a model with caps on it and that's appropriate because the Postal Service still performs a public function, it has to deliver and deal with mail in the far corners where you wouldn't expect the private sector to earn a profit. On the other hand, we have said, but you're supposed to act like a private sector company, you know, make some money, take care of yourself.

And you indicate that they're certainly going to have a hard time doing that if they don't have something close to perfect data and that they'd have to get that data in a fairly refined way, using technology and almost a quick response or proactive way.

Well, my question is given the coexistence of a private sector and a public sector model in the same body, suppose you did have perfect data and you were dealing only with where—I think you call them noncap issues. Noncap issues, you know, like express mail. I guess priority mail. There are not a lot of those. And there's heavy competition from the private sector, which consists often wholly of that kind of mail.

And I am very pleased that the post office has been able to break into it at all. But of course, part of it is by the same way anybody would operate in the private sector, underpricing them, trying to improve on it. You know, even for commercial magazines, they are capped in terms of what you can charge. I mean, the magazines themselves earn a lot of money, leave aside nonprofits. I'm talking about the Time Magazines and whoever it is that uses the mail. But of course, you have to do that because otherwise they'll move someplace else in order to send their magazines out.

I just have to ask you, and you know, let's assume that we get some perfect data. How close will that come to solving this conundrum so that perfect data—I mean, that's my model, I'm assuming it. I recognize how difficult it is—will somehow make it easier for them to set—to do pricing according to their market; of course, pricing according to the market brings other problems with it, like competing in the market. And whether you know of any model in the world where the public and private components are combined that we might look more closely at.

Finally, just let me give the model—push private sector pricing into models that any fool would know they won't work. For example, and the post office has done better than Amtrak. The private

sector turns over Amtrak to the Federal Government in 1970 and said, we surely can't deal with this. This doesn't fit our pricing model. We go out of business. Here, government, you take it. And this administration has trying to treat Amtrak as if, once again, like any private railroad, except if you look at the world at large, there is no such thing as a railroad which is not subsidized heavily by its government. And so you have all kinds of extraordinary rail travel throughout Europe and Asia. And we're sitting here with Amtrak not having enough money even to take care of its security problems.

So my question goes you know, do we have any model to work from if we have perfect data? How much or do you think this would solve the problem given the noncap, small, maybe 10 percent of the business is noncap that has to compete with highly competitive, highly efficient international corporations that do that business all over the world. I would just like to hear you just opine on this issue or whether we're about to drive the post office into the ground the way we have Amtrak.

Mr. WOLAK. Well, I think what you're really referring to, at least I'll recast it as is that it's really the USO—universal service obligation, I would classify that as sort of the government aspect and in the private. And I think that is really a major issue going forward for the Postal Service and the Postal Regulatory Commission. And even in a world with perfect data, there are, as I note in my testimony, some really difficult and conceptual issues in terms of thinking about is, you know, I think your point exactly.

Many of the rail lines that exist in Europe exist purely I think for USO reasons, in the sense that there is a desire of the government to say, we should provide transportation even if its uneconomic to these areas because we think, you know, there is a public benefit aspect to it. And that's the essential feature of the universal service obligation. We define an obligation that really doesn't make economic sense but it makes, you know, greater sense in the greater good sense. And that really is the issue. And that exists, I think, to a lesser extent in other network industries. And at least to my mind makes them very interesting.

In the telecom sector, we have the universal service obligation that we want to provide everyone with access to telephone service. But the trouble is telephone service has become so cheap that it's not nearly as hard to do that, and similarly with electricity. But we have a, you know, to provide universal access to people. The Postal Service presents a more challenging, you know, universal service obligation just because of how it's been defined. As I put a stamp on that letter and that stamp delivers it to anywhere in the United States. And you know, regardless if its across the street or in the Grand Canyon, and you know, that's a very challenging process that makes the determination of that. But if you like, you give me the ideal data, I will give you the ideal outcome. The ideal outcome is we take the ideal data and we figure out what that cost is and we recover that cost to make sure that the universal service obligation is met and then we say OK, Postal Service subject just to the fact that you have to make some contribution to fixed cost from the competitive products, we give you complete flexibility in,

you know, how you price those to compete against the vigorous competition that you face.

But it is a—I definitely think a very major challenge to figure out first just what is that universal service obligation and the second is, what is the cost of it? And I think that's a very important discussion that needs to take place, given that, you know, the discussion I had with the chairman of the changing role of interpersonal communications that results from the fact that we have the Internet and these sorts of things so we may want to revisit what the USO obligation really is. But that's something for——

Ms. NORTON. I just don't think there's any chance we're going to revisit that obligation. The one thing that happens in this place when you talk about revisiting that obligation is you get—there's one issue that gets you a universal vote with no dissents. So that's the conundrum of which I speak. And I just think we have to reinvent the model. I must say this whole notion of flexibility price, there is no such thing as price flexibility. Private sector has no flexibility. You know, it is more discipline. You might not call it a cap. But if it wants to stay in business, it's got to compete with other people who want to do the business more efficiently and at less cost. They have very little flexibility.

And so they do it—in all manner of ways. So we gave them the quote same flexibility. You know, here's your flexibility. Go and compete with, you know, express mail or go and compete with the people who invented this whole new way of doing what you do.

On management, the Postal Service itself, of course, is unionized. We approve of that. Management in the Postal Service is—I'm not sure what the nature of the regulation there is. But these are people who operate as managers. There might be some problems with pay-for performance, although I do understand they do some of that. But in terms of efficiency or good managers, is there any reason to believe that the Postal Service couldn't attract the same kind of managers that Federal Express or some of those people attract? We keep them from getting those managers where there may be more flexibility than in a unionized work force.

Mr. WOLAK. Well, there certainly is far greater flexibility to pay-for performance in the private sector than in the Postal Service. And that certainly I think has, you know, both positive and negatives.

Ms. NORTON. Yeah, well we've seen the negatives. And that's not what this committee—but again, is that what—is the kind of management we have in the Postal Service that much different from the management of similar noncapped services provided in the private sector?

Mr. WOLAK. Well, I certainly think your point of the—certainly one way that a number of the other firms perhaps are less encumbered is the degree of the unionization. And I don't want to, you know, I don't want to comment to anything on that, so that can make it more difficult for the managers to——

Ms. NORTON. I don't really think that's our problem. What happened was Federal Express invented a whole new way of rapidly dealing with the mail. Yes, they're not unionized. But in order to remain competitive with the Postal Service, for that matter, they've got to pay very well. The way in which you—the challenge for the

Postal Service is a challenge not unlike the challenge that American Express had. OK, invent a model, a new model that fits this universe. The universe they found was a universe in which there was not express mail and which you couldn't do things overnight, in which you couldn't shift things that were perishable quickly, so they invented a model that fit them. What I'm suggesting, this model is a jerry-built model that——

Mr. WOLAK. Oh, no, no, no.

Ms. NORTON [continuing]. Seemed to satisfy neither side but the moment we want to change the universal model, people scream and obviously doesn't satisfy the competitive side because they're competing with people for who they must underprice or become vastly more efficient than in order to even stay in the game. So I don't even see those two coexisting in the same universe.

Mr. WOLAK. I guess I would say that as someone who has visited a number of postal sorting facilities, I mean, they're very modernization operations, they have state-of-the-art equipment, I think the are using modern management practices as much as possible. But I guess the—you know, what I would say is that there's—you know, the simple way to describe it I think would be is there's looking at things in terms of how much labor do I put in and how many pieces do I get sorted? But when you are operating in a market context, it's more of how many dollars of labor—or how many dollars do I spend on this? How much, therefore, sales do I get at the other end? And how much contribution am I getting to pay for my fixed costs? And it's sort of a—in the market environment, that's really what you are interested in.

So even if suppose it's very costly for you to do something, if what you are able to sell it for is something very high, that's something that in a market environment you are going to do, and I think that's the transition that is taking place under the act and is hopefully being, you know, taking place, is a recognition of you are competing in the marketplace, that it really is how are you getting contribution to fixed cost rather than just simply improving the efficiency of postal operations in the sense of, you know, amount of labor hours, amount of pieces sorted. And if the pieces you are sorting aren't the ones and doing a good job of sorting aren't the ones that are really high value to you and you are probably not as good as sorting the ones that are extremely high valuable to you, then you would probably want to get more of those. And that's, I think, the new model. And I think that's where you know understanding how you're making your money is really the change in the world. And that's just not something in a monopoly environment that you really need to be concerned with because the monopoly environment guarantees you essentially cost recovery whereas the competitive environment doesn't.

And so you really have to be much more cognizant of that and the price gap mechanism in some sense is trying to say, look, you really have no ability to move your prices. They will simply increase at this CPI. So, you know, try your best to figure out the best place to try to sell your products to you know scale down your operations to do that.

Ms. NORTON. Thank you, Mr. Chairman. I thank you, Mr. Wolak. Mr. Chairman, I believe that this perfect data might well tell the

Postal Service to raise prices in the noncap areas. If you want to deal with their revenue problems which are immense, and look what that would mean in competing with Federal Express and the rest of them. That's why I think this is a—we need a whole new model. And I accept the private sector model and I accept the universal service model and I don't know what to do about it. Thank you very much.

Mr. WOLAK. Thank you.

Mr. DAVIS OF ILLINOIS. Thank you very much, Representative Norton. Thank you, Mr. Wolak. We appreciate you coming.

Mr. WOLAK. Thanks.

Mr. DAVIS OF ILLINOIS. We will now move to panel 2. Ms. Katherine Siggerud is a Director in the Physical Infrastructure Issues team at the Government Accountability Office [GAO]. She has directed GAO's work on postal issues for several years, including recent reports on delivery standards and performance, process and network realignment, contract and policies, semipostal stamps and biological threats. Thank you very much, Ms. Siggerud. It is our custom to swear in all the witnesses.

[Witness sworn.]

Mr. DAVIS OF ILLINOIS. The record will indicate that the witness answered in the affirmative. We thank you very much for coming and for being here. Your full statement is in the record. If you would take 5 minutes and summarize for us, we'd appreciate that. Thank you very much.

STATEMENT OF KATHERINE SIGGERUD, DIRECTOR, PHYSICAL INFRASTRUCTURE ISSUES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Ms. SIGGERUD. Chairman Davis, Ms. Norton, members of the subcommittee, thank you for your invitation to testify at today's hearing concerning the implementation of the Postal Accountability and Enhancement Act. When I testified about a year ago before this subcommittee, I said that the Congress's efforts to pass comprehensive wholesome reform provided opportunities to address many of the Postal Service's challenges. We are now at the point where we can begin to assess the act's implementation. Today I will focus on first, actions to date resulting from the act including how they affected the service's 2007 financial condition, and second, continuing challenges in areas for oversight. My full statement also covers how studies required under the law can contribute to future postal reform decisions. My statement today is often a positive one, as we are encouraged by the early steps that the service, the PRC, mailers and the stakeholders have taken. They have found new ways to engage in constructive dialog and in several cases reach consensus on how best to proceed. These actions, which contrast sharply with the former adversarial ratemaking process hold promise for a future progress across a broad range of postal reform issues. Such collaboration and progress will remain necessary as the service and the mailing industry transform themselves in response to the rapidly changing marketplace and continue to implement these reforms.

Turning now to implementation of the act. The service, the PRC and other postal stakeholders have worked cooperatively to date to

meet their responsibilities in fulfilling its requirements. Key actions include establishing first, early regulations for a new rate-setting system which influence the service's decision to pursue its proposed rate increase under the new system. Second, a mechanism that requires prefunding of retiree health insurance premiums, thus distributing this burden between current and future rate payers. And third, modern service standards for the service's products covered by the postal monopoly.

These were the result of a collaborative effort and were the most sweeping update in years. In addition, several reports required under the act have been issued and the PRC has solicited comments and held meetings to simulate dialog on the complex issues related to the new regulatory framework. In terms of impact, the service reported a $5.1 billion net loss for 2007. Other aspects of the act, such as retiree health obligations directly affected these results. Costs such as wages, fuel and adding 1.8 million new delivery points. This left the service with a total debt of $4.2 billion. With regard to challenges and areas for oversight, we have in the past called attention to basic challenges facing the services, such as changing mail volumes and increasing delivery points. And these remain relevant today. They are exacerbated by our current economic environment. A slowing economy, recent rate increases and other factors negatively affected the postal service's financial performance in the first quarter of 2008. Its mail volumes and revenues, particularly the key products of first class and standard mail, were lower than planned.

The service was able to respond by cutting costs. Although the service anticipates additional revenues from its proposed rate increase, additional cost reductions beyond those that had been planned will be needed to meet its financial projections for 2008. We have also followed the service's challenges and improving its efficiency. This includes realigning its processing and other infrastructure.

The act requires the service to develop a plan by June for rationalizing its spent work and removing excess processing capacity. This provides the service the opportunity to make its case for continued action and address concerns and recommendations raised by the PRC, the postal IG and GAO. The service also plans several new technology investments that have the potential to increase efficiency such as a system to sort flat shaped mail in the transition to the intelligent mail bar code. There is also the significant challenge of measuring the reporting on the quality of service for most postal products. The Postal Service must, in consultation with the PRC, submit a plan to Congress by June for how it will meet its newly established standards including performance goals and must then begin to report on performance. The service and its stakeholders have made good progress to date and our work suggests that. With regard to reporting, key principles of completeness, availability and usefulness should guide future actions and that this should continue to be a collaborative effort.

In conclusion, Mr. Chairman, given these challenges, key areas for continued oversight include how mailers and mail volume have and will respond to rate changes, the effects of changes in mail volume and revenue on the service's financial condition, efforts to con-

trol cost by modernizing and optimizing the Postal Service's infrastructure and work force, the transition to new automation and mail tracking systems and the level of transparency and measuring and reporting on delivery performance. This completes my statement. I'm happy to answer any questions you may have.

[The prepared statement of Ms. Siggerud follows:]

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Federal Workforce, Postal Service, and the District of Columbia, Committee on Oversight and Government Reform, House of Representatives

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POSTAL REFORM LAW

Early Transition Is Promising, but Challenges to Successful Implementation Remain

Statement of Katherine Siggerud, Director
Physical Infrastructure Issues

GAO-08-503T

February 28, 2008

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-08-503T, a testimony before the Subcommittee on Federal Workforce, Postal Service, and the District of Columbia, Committee on Oversight and Government Reform, U.S. House of Representatives

POSTAL REFORM LAW

Early Transition Is Promising, but Challenges to Successful Implementation Remain

Why GAO Did This Study

In December 2006, Congress passed the first comprehensive postal reform legislation in over 30 years. The Postal Accountability and Enhancement Act (the act) provided opportunities to address many of the financial, operational, and human capital challenges facing the Postal Service (the Service), which contributed to GAO's decision to remove the Service's transformation efforts from its High-Risk List last year. Specifically, the act provides tools and mechanisms that can be used to establish an efficient, flexible, fair, transparent, and financially sound Postal Service—one that can more effectively operate in an increasingly competitive environment not anticipated under the Postal Reorganization Act of 1970.

This testimony focuses on (1) the actions to date resulting from implementing the act and how it affected the Service's 2007 financial condition, (2) the implementation challenges and areas for continued oversight, and (3) how information required under the law can contribute to future postal reform decisions. The testimony is based on GAO's past work; a review of the implementation of the postal reform law, including actions already taken; and updated information on the Service's financial and operational condition. The Postal Service had no comments on this testimony.

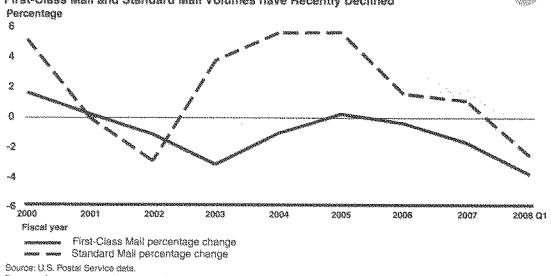
To view the full product, including the scope and methodology, click on GAO-08-503T. For more information, contact Katherine Siggerud at (202) 512-2834 or siggerudk@gao.gov.

What GAO Found

Over the last 14 months, key actions have been taken to implement the act. For example, a new rate-setting system and regulatory agency were established, the Service began prefunding its retiree health benefit obligations, service standards were updated, and key reports were issued. These actions have required the collective efforts of many postal stakeholders including the Service and the Postal Regulatory Commission. The Service reported a $5.1 billion net loss for fiscal year 2007. Some of the actions taken to implement the act, such as funding changes to its retiree health benefit obligations and pension requirements, directly impacted these results, as did other events such as the January 2006 and May 2007 rate increases.

The uncertain economic environment serves to exacerbate the challenges facing the Service and contributed to lower than expected mail volumes and revenues in the first quarter of fiscal year 2008. The Service projects a $600 million net loss for 2008 as it faces challenges such as generating volumes (see figure) as rates increase again in May; managing its costs and improving operational efficiencies through accelerated cost reduction strategies; maintaining, measuring, and reporting service; and managing its workforce.

First-Class Mail and Standard Mail Volumes have Recently Declined



Source: U.S. Postal Service data.

Some key areas for continued oversight include changes to mail volumes and revenues, efforts to control costs by optimizing the Service's infrastructure and workforce, transition to new automation and technology to enhance mail sorting and tracking, transparency in measuring and reporting delivery performance, and implementation of the new rate-setting regulations.

Information required under the act can be used to facilitate constructive dialogue about complex postal reform issues that may eventually need to be revisited by Congress. The act requires multiple reports and studies over the next 5 to 10 years that can be used to continually examine and assess the Postal Service's position in an environment of increasing competition and technological advan Specifically, these reports and studies will provide key information on the Service's mission and role, monopoly protections, universal service requirements, rate-setting and other regulatory issues, oversight structure, competition issues, and consumer protection.

Chairman Davis, Representative Marchant, and Members of the Subcommittee:

I am pleased to be here today to participate in this oversight hearing for the U.S. Postal Service (the Service). At last year's oversight hearing, I testified that Congress's efforts to pass comprehensive postal reform provided opportunities to address many of the financial, operational, and human capital challenges facing the Service.[1] Specifically, the Postal Accountability and Enhancement Act (the act)[2] provided tools and mechanisms that can be used to establish an efficient, flexible, fair, transparent, and financially sound Postal Service—one that can more effectively operate in an increasingly competitive environment not anticipated when the Postal Service was created under the Postal Reorganization Act of 1970. These fundamental changes contributed to GAO's decision to remove the Postal Service's transformation efforts from our High-Risk list in January 2007.[3]

My remarks today will focus on (1) the actions to date resulting from implementation of the act, including how it affected the Service's 2007 financial condition,[4] (2) the implementation challenges and areas for continued oversight, and (3) the way information required under the law can contribute to future postal reform decisions. My statement is based on work we conducted in January and February 2008, including reviewing such Postal Service documents as the 2007 Audited Annual Report and Comprehensive Statement, 2008 Integrated Financial Plan, the financial report for the first quarter of 2008, updated Strategic Transformation Plan; reports and information related to the act; and our past work. We also interviewed Postal Service officials. We conducted this performance audit in accordance with generally accepted government auditing standards.

[1]GAO, *U.S. Postal Service: Postal Reform Law Provides Opportunities to Address Postal Challenges*, GAO-07-684T, (Washington, D.C.: April 17, 2007).

[2]Pub. L. No. 109-435: The Postal Accountability and Enhancement Act, enacted Dec. 20, 2006.

[3]In GAO, *High-Risk Series: An Update*, GAO-07-310 (Washington, D.C.: January 2007), we determined that sufficient progress had been made to warrant removing the Postal Service's transformation efforts and outlook from our high-risk list. We had originally made this designation in April 2001 to reflect its growing financial, operational, and human capital challenges.

[4]Unless otherwise noted, all references to specific years refer to the Postal Service's fiscal year, which ends on September 30.

Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Summary

The Postal Service, the Postal Regulatory Commission (PRC),[5] and other postal stakeholders have worked cooperatively to date to meet their responsibilities in fulfilling the requirements of the act. Some of the key actions include establishing

- regulations for a new rate-setting system and the Service's decision not to implement another rate increase under the old system,
- the new PRC and its Office of Inspector General (OIG),
- a retiree health benefits fund, held by the U.S. Treasury for prefunding retiree health insurance premiums, and transferring into this fund the surplus for postal employees under the Civil Service Retirement System (CSRS), and
- modern service standards for the Service's products covered by the postal monopoly.

In addition, several reports required under the act have been issued, and the PRC has solicited public comments and held meetings to stimulate constructive dialogue on some of the complex issues involved in establishing the new regulatory framework. The Service reported a $5.1 billion net loss for 2007. Some of the actions taken to implement the act, such as funding changes to its retiree health obligations and pension requirements, directly impacted these results, as did other events such as rate increases in January 2006 and May 2007.

The financial, operational, human capital, and regulatory challenges facing the Service and other stakeholders as they take actions to continue implementing the act are exacerbated by the current uncertain economic environment. A slowing economy, recent rate increases, and other factors

[5]The Postal Regulatory Commission was previously named the Postal Rate Commission. Section 604 of the act redesignated the Postal Rate Commission as the Postal Regulatory Commission.

have negatively impacted the Service's financial performance in the first quarter of 2008—its mail volumes and revenues were both lower than planned. The Service was able to mitigate these impacts by managing cost growth while achieving record service delivery performance for the segment of First-Class Mail[6] that is currently measured.[7] In response to concerns about challenges to its financial outlook, the Service filed its first rate increase for its market-dominant products[8] under the act on February 11, 2008. This rate increase, which averages about 2.9 percent for the majority of its products, is scheduled to take effect on May 12, 2008. Service officials stated this increase is expected to contribute an additional $700 million in revenues for 2008, and will need to be supplemented by accelerated cost reduction strategies totaling $2 billion for the year to achieve its year-end target of a $600 million net loss. The Service has also updated its strategies for addressing challenges related to achieving efficiencies through automation and improving service. Some key areas for continued oversight include changes in mail volumes and revenues, efforts to control costs by modernizing and optimizing the Postal Service's infrastructure and workforce, the transition to new automation and mail-tracking systems, the level of transparency in measuring and reporting delivery performance, and the implementation of the new rate-setting processes and regulations.

Information required under the act can be used to facilitate constructive dialogue about postal reform issues related to universal service, the postal monopoly, fair competition, consumer protection, and transparency and accountability. Specifically, the act included provisions for reports required over the next 5 to 10 years related to examining and reporting on the Postal Service's mission, role, and oversight structure in an

[6]First-Class Mail includes single-piece mail (e.g., bill payments and letters) and bulk mail (e.g., bills and advertising).

[7]This segment of mail is measured using the External First-Class Measurement System (EXFC). The EXFC system is not a system wide measurement of all First-Class Mail performance. According to the Service, EXFC continually tests mail deposited in collection boxes in 463 three-digit zip code areas selected for geographic and volume density.

[8]The act created different pricing mechanisms for the Service's competitive and market-dominant products. Market-dominant products include those products protected by the postal monopoly, such as First-Class Mail letters, Standard Mail (mainly bulk advertising and direct mail solicitations), and Periodicals (mainly magazines and local newspapers) and competitive products are not protected by the postal monopoly and include Priority Mail and Expedited Mail. Sections 201 and 202 of the act list which products are market-dominant and competitive.

increasingly competitive environment.[9] This work was to be performed by multiple stakeholders, including the Postal Service, PRC, the Postal Service OIG, the Office of Personnel Management (OPM), Treasury, and GAO, with a wide range of deadlines. We look forward to reviewing this information as part of the evaluation we are required to conduct under the act of various options and strategies for long-term structural and operational reforms to assure that the Postal Service can continue providing affordable universal postal service.

Key Actions Have Been Taken to Implement the Act

Several key actions have been taken to implement the law since it was enacted over 14 months ago. Some of the actions taken to implement the act had a direct impact on the Service's 2007 financial condition, while others facilitated the transition to a new financial, operating, and regulatory environment. Specific actions in the act that have affected the Service's 2007 financial condition include:

- prefunding the Service's significant unfunded retiree health obligations. While this change results in significant retiree health benefit cost increa for a decade, over the long term this action improves the fairness and balance of the cost burdens for current and future ratepayers. The Service's 2007 payment of $5.4 billion was the first of 10 annual payments required under this change.[10]
- expensing almost $3 billion in funds previously set aside in escrow (transferring them to the Treasury) and eliminating future escrow payments, including an estimated $3.3 billion payment that had been scheduled for 2007.[11]
- transferring the estimated $27 billion funding obligation for selected military service benefits back to the Treasury.
- eliminating certain annual CSRS pension funding requirements, thereby saving the Service approximately $1.6 billion in 2007.

[9]For a listing of these reports and actions, see Congressional Research Service, *The Postal Accountability and Enhancement Act*, RS22573 (Washington: D.C.: Jan. 22, 2007).

[10]These payments go into the newly created Postal Service Retiree Health Benefit Fund (PSRHBF).

[11]The Postal Civil Service Retirement System Funding Reform Act of 2003 required the Postal Service to escrow the reduction in its civil service pension expenses that resulted from changes to how the Service funded these pensions.

The effects of these changes, however, must be put into context with other actions and events during this time to gain a comprehensive understanding of the Service's financial and operating condition. For example,

- Mail volumes and revenues: Total revenues of nearly $75 billion dollars in 2007 represented an increase of 3 percent from 2006. This revenue increase, however, was largely attributable to the January 2006 and May 2007 rate increases—not mail volume increases.[12] In particular, the Service experienced an overall decline in mail volume from 2006 of over 900 million pieces (a 0.4 percent decline), largely due to a decrease of 1.7 billion pieces of First-Class Mail and the smallest increase in Standard Mail volumes since 2001.

- Operating costs: Total operating expenses of over $80 billion in 2007 represented an increase of nearly 12 percent from 2006. This increase was largely due to a net increase of $6.8 billion in expenses that resulted from requirements of the act described earlier.[13] The Service was also affected by increases in postal wage rates; rising fuel costs (its transportation costs grew by almost 8 percent); and the extension of mail service to an additional 1.8 million delivery points.

- Productivity and cost control: The Service was able to partially mitigate these cost pressures by improving productivity for an eighth consecutive year. The Service reported a 1.7 percent increase in productivity, which is equivalent to $1.2 billion in cost savings. The Service reduced over 36 million workhours, partly by downsizing its career workforce by over 11,000 employees.

[12]The January 2006 rate increase was on average, 5.4 percent, and the First-Class stamp rate went from 37 cents to 39 cents. The May 2007 rate increase was, on average, 7.6 percent and the First-Class stamp rate increased to 41 cents. As part of this rate change, the Service sought to align postal rates with the respective mail handling costs. Some rate increases recommended by the PRC and implemented by the Service were particularly large, including some catalog rates that increased by 20 to 40 percent. The new rate structure is aimed at providing greater incentives for more efficient mailing practices (e.g., shape, weight, handling, preparation, and transportation) and thereby encouraging smaller rate increases in the longer run.

[13]The $6.8 billion net increase in expenses as a result of changes in the act consists of the new retiree health benefit payment ($5.4 billion) and the expensing of escrow monies ($3.0 billion), being offset by the $1.6 billion reduction in CSRS expenses.

- Labor agreements: The Service negotiated agreements with 3 of its 4 major unions on wages, many benefits, and conditions of employment in 2007.[14]

- Debt: The Service's outstanding debt increased $2.1 billion in 2007, doubling its 2006 debt balance to $4.2 billion.[15] These increases were primarily used to finance year-end worker compensation and retiree health payments.

- Capital: The Service reported a slight increase in capital cash outlays of $2.6 billion in 2006 to $2.7 billion in 2007. These funds were used for such projects as new facilities, automation equipment, and carrier vehicles.

- Service performance: According to the Service, it reported record annual on-time performance for First-Class Mail measured by the EXFC system. The Service reported on-time performance for 2007 of 96 percent for its 1-day mail, 93 percent for its 2-day mail, and 90 percent for its 3-day mail.

The net income reported for 2007 was a $5.1 billion loss. Removing the financial impact of the new law, the Postal Service's net income would have been $1.6 billion (which was $100 million less than the $1.7 billion originally budgeted for the year). Because of the new law, however, the Service required an additional $500 million in cash to cover the differences between the net increase in retirement-related expenses of $3.8 billion[16] and the expected $3.3 billion escrow payment that was avoided.

Aside from its direct financial impact, the act required other actions to facilitate the transition to a new financial, operating, and regulatory environment. Table 1 summarizes key actions.

[14]The agreement with the fourth major union resulted from a binding arbitration decision issued in December 2007.

[15]The Service's annual debt limit is $3 billion, and its total debt limit is $15 billion.

[16]The $3.8 billion net increase in retirement-related expenses is comprised of the $5.4 billion retiree health payment due in 2007 and the $1.6 billion reduction in the Service's pension expenses in 2007.

Table 1: Summary of Selected Key Actions Taken to Implement Postal Reform Law

Date	Party responsible	Action taken
May 2007	The Service's Office of the Inspector General (OIG)	Issued a report on workplace safety that found the Service exceeded its workplace safety goals for 2005 and 2006, but also recommended that the Service monitor costs associated with accidents.
June 2007	The Office of Personnel Management (OPM)	Determined the Postal Surplus/Supplemental Liability as of September 30, 2006, regarding the Civil Service Retirement System.
November 2007	The Postal Regulatory Commission (PRC)	Issued regulations that established the new rate-making system. The regulations consist of three parts: (1) regulations related to rate adjustments for market-dominant products, including the formula for calculating the price cap; (2) regulations related to competitive products; and (3) a Mail Classification Schedule, which categorizes products as either market dominant or competitive.
	The Postal Service's OIG	Issued a report on the adequacy and fairness of the process for assessing certain rate deficiencies. This report found the assessments and appeals process was adequate and fair, and that there was no compelling reason for Congress to assign an outside body a role in this process. It did identify issues with the Service's monitoring of revenue deficiencies and updating of procedures. It determined that a statute of limitations on the assessment of revenue deficiencies was not necessary.
December 2007	The Postal Service Board of Governors:	Issued *Board of Governors' Report to the President and Congress on the Representation of Women and Minorities in Supervisory and Management Positions in the United States Postal Service*. This report included diversity information for both supervisory and management positions, as well as for the workforce as a whole.
		Issued *Board of Governors' Report to the President and Congress on United States Postal Service Contracts with Women, Minorities and Small Businesses*. This report stated the Service exceeded its annual goals by almost 12 percent for contracts issued by minority-owned and almost 22 percent for women-owned businesses in 2007.
	The Postal Service:	Filed its 2007 Annual Compliance Report on the costs, revenues, rates, and quality of service associated with its products to the PRC for its evaluation. The PRC stated this report did not contain all of the information that normally would be provided, noting that it was the Service's first report under the act's tight deadline for filing within 90 days after the end of the fiscal year. The PRC also has stated that the report was prepared without the guidance of PRC regulations governing its form and content, which were under development at the time. PRC solicited public comment on the report, including on the degree to which the Service's operations and financial results complied with the policies of title 39 of the U.S. Code (i.e., the nation's postal laws).
		Published regulations to establish modern service standards for its market-dominant products, including mail covered by the postal monopoly.
	The Department of Treasury	Issued a report with recommendations on accounting practices and principles that should be followed by the Service. The PRC is soliciting public comment on the report, including what financial transparency and oversight are appropriate for the Service's Competitive Products Fund and who should conduct such oversight.

Date	Party responsible	Action taken
	GAO	Issued an interim report: *Postal Service and Mailing Industry Mail-Related Recycling: Accomplishments and Postal Opportunities.* This report found that postal stakeholders have undertaken numerous mail-related recycling initiatives, but the extent to which these initiatives have been adopted is unknown. Additionally, stakeholders identified opportunities for the Service to engage in, or encourage others to engage in, mail-related recycling. The full report will be issued later this year.
	The Federal Trade Commission (FTC)	Issued the *Accounting for Laws That Apply Differently to the United States Postal Service and Its Private Competitors* which identified and analyzed laws that apply differently to the Service's competitive products and similar products provided by private competitors, and estimated the Service's economic burdens and advantages due to these legal differences. The report discussed ways that the PRC or Congress may be able to minimize or eliminate marketplace distortions.

Source: GAO analysis of Pub. L. 109-435.

As indicated in table 1, multiple stakeholders have taken actions to implement the requirements of the act. While each of these actions is important, I would like to highlight the efforts of the Postal Service and other stakeholders in modernizing service standards and of the PRC in transitioning to its new regulatory responsibilities.

- Service standards: The Service has made important progress in implementing the act's requirements to establish modern service standards for market-dominant products. The Service's approach to developing these standards incorporated a high level of collaboration with mailers, consultations with the PRC, and comprehensive review of its network capabilities. A workgroup involving nearly 200 representatives from the Service, mailing organizations and mailers, and other members of the mailing industry was particularly noteworthy for its efforts to identify issues and build consensus in this area. The result was the most sweeping update in delivery performance standards in many years. In particular, standards for Periodicals, Package Services, and Standard Mail that dated back many years were realigned with current postal operations.[17]

- Regulation: A key tenet of the act was to provide the Postal Service with more flexibility to set prices and introduce new products. The act, however, balanced this flexibility by granting the PRC enhanced regulatory authority to regulate these activities, and to, among other things,

[17]Package Services include parcels, merchandise, catalogs, media mail, library mail, and books.

- regulate rates for market-dominant products and services;
- monitor financial and service performance;
- ensure financial transparency and data quality; and
- act on complaints against the Postal Service.

The PRC has made good progress in its transformation, particularly in establishing a new ratemaking system. The PRC issued its first set of rate regulations almost 8 months ahead of the statutory deadline, and the Postal Service recognized this achievement and chose not to file another rate case under the old system. The PRC set up its new organizational structure, including the new PRC Inspector General, as well as revising key rules and regulations to reflect implementation of the act. The PRC has also taken an active role in consulting with the Service on its service standards and performance measures, solicited public comments, and held hearings and meetings to stimulate constructive dialogue among the parties.

Remaining Implementation Challenges Exacerbated by Economic Uncertainty

The financial, operational, human capital, and regulatory challenges facing the Service and other stakeholders as they take actions to continue implementing the act are exacerbated by the current uncertain economic environment. The Service noted in its 2008 budget that it expected a net increase in costs of $1 billion net for 2008 from changes in the law.[18] In addition, a slowing economy has negatively affected the Service's financial performance in the first quarter of 2008—its mail volumes and revenues were both below planned amounts. The Service was able to mitigate these challenges by managing cost growth while achieving record service delivery performance for the segment of First-Class Mail that is currently measured. To address concerns about its challenged financial outlook, the Service filed a rate increase February 11, 2008, averaging about 2.9 percent for the majority of its products. This increase is scheduled to take effect on May 12, 2008, and is the first of its type under the new law. According to Service officials, this increase is expected to contribute an additional $700 million in revenues for 2008, but will need to be supplemented by

[18]This negative $1 billion impact in 2008 is based on the difference between eliminating $5.1 billion in costs ($1.5 billion in CSRS contribution and $3.6 billion that was to be placed into escrow) being offset by $6.1 billion in additional payments and lost interest income on the escrow monies.

accelerated cost reduction strategies to achieve its year-end target of a $600 million net loss. The Service has updated its strategies for addressing challenges under the new law related to generating sufficient revenues, achieving efficiencies through automation, and improving service. In particular, to help address its revenue challenges, the Service has indicated that it plans to fully use its pricing authority under the rate-setting cap to implement smaller, more frequent, predictable rate increases, as well as work with its customers to develop new products and services. It also plans for $2 billion in cost reduction efforts in 2008. Some of the key areas for continued oversight include changes in mail volumes in response to more frequent, predictable rate increases; efforts to control costs by modernizing and optimizing the Postal Service's infrastructure and workforce; the transition to new automation and mail-tracking systems; the level of transparency in measuring and reporting delivery performance; and the implementation of the new rate-setting processes and regulations.

Generating Sufficient Revenues as Mail Volumes Decline and the Mail Mix Changes

The Service continues to face challenges in generating sufficient revenu as mail volumes are declining and the mail mix is changing. This challenge became more evident after the Service's revenue and volume results for the first quarter of 2008 were released. Volumes were down 1.7 billion pieces (3 percent) compared with quarter 1 in 2007 (see table 2), with notable declines in the two major mail classes: First-Class Mail and Standard Mail. These results are of particular concern because they occurred during a typically strong volume quarter that includes the holiday mailing season.

Table 2: First Quarter Volumes for the Service's Major Mail Categories

Class	2008 quarter 1	Percent change from quarter 1 2007
First-Class Mail	24.4 billion	-3.9%
Standard Mail	27.7 billion	-2.6
Periodicals	2.2 billion	1.2
Express Mail	12.3 million	-10.9
Priority Mail	240.4 million	-4.9
Package Services	318.2 million	-3.4
Total all mail	**55.4 billion**	**-3.0%**

Source: U.S. Postal Service data.

Key declines during this time took place within the two largest categories, First-Class Mail and Standard Mail. In particular, volumes declined for flat-sized Standard Mail (e.g., catalogs) by 13 percent; for flat-sized First-Class Mail (e.g., large envelopes) by 15 percent; and single-piece First-Class Mail by nearly 7 percent. As a result of the overall declines in mail volume, revenues were $500 million less than planned. The Service attributed these volume declines and revenue shortfalls to multiple factors, including the effects of the May 2007 rate increase; a slowing economy with declines in the financial and housing industries, business and consumer confidence, and rising fuel and paper prices; increasing competition from other advertising media; and the continued diversion of single-piece First-Class Mail to electronic alternatives such as Internet bill payment and direct deposit.

The declines in First-Class Mail volume in the first quarter of 2008 parallel the ongoing trends of First-Class Mail in general. This class of mail, once with the largest volumes and revenues, saw volumes decline by more than 7 percent between 2001 and 2007. The Service's First-Class Mail volume estimate of 95.4 billion pieces built into its 2008 budget would be a slight decline from 2007 levels and would be the lowest volume level since 1994. These declines in First-Class Mail were mitigated in past years by growth in Standard Mail volumes and revenues. Standard Mail volumes exceeded those for First-Class Mail for the first time in 2005. This change was significant, in part because Standard Mail is more sensitive to prices and economic conditions and it takes about two pieces of Standard Mail to make the same contribution to the Service's overhead costs as one piece of First-Class Mail. The Service's 2008 budget planned a modest 1.1 percent growth in Standard Mail volumes because of such factors as the effects from the May 2007 rate increase and a projected slowness in the economy. The Service stated in its first quarter report for 2008 that these factors, among others, had an adverse impact on volumes as Standard Mail volumes declining by 2.6 percent compared to the first quarter of 2007. For the remainder of 2008, mail volumes and revenues will continue to face many of the same challenges that affected its first quarter results, particularly economic uncertainty and the impacts of rate increases.

The Service recognizes that the law provides opportunities to address the revenue challenges it faces and that "cost cutting alone cannot sustain the business." The act specifically provides tools and mechanisms to help promote revenue generation and retention of revenues. The act established more timely, flexible pricing mechanisms for the Service's competitive and market-dominant products. For example, it allows the Service to use a streamlined process for raising the rates for its market-

dominant classes, such as First-Class Mail, Standard Mail, and Periodicals, up to a defined price cap; to exceed the price cap should extraordinary or exceptional circumstances arise; and to use any unused rate authority within 5 years. For its competitive products, such as Priority Mail or Expedited Mail, the Service may raise rates as it sees fit, as long as each competitive product covers its costs and competitive products as a whole cover their attributable costs and make a PRC-specified contribution to overhead. The act also allows for new, customized products and services, as well as for the Service to retain any earnings, which may help finance capital investment and increase financial stability. In its updated Strategic Transformation Plan, the Service states that it plans on taking advantage of these new flexibilities through such actions as

- improving the value of its market-dominant products through such tools as Intelligent Mail,[19]
- tailoring competitive products to market requirements,
- enhancing online postal services, and
- streamlining acceptance of mail at postal facilities for commercial mailers.

The Postal Service applied its new rate-setting flexibilities when, on February 11, 2008, it announced its first rate increases under the act for its market-dominant products, including an increase in the cost of a First-Class stamp from 41 to 42 cents. The Service intends to raise the rates for each class,[20] on average, close to the maximum allowed by the price cap (2.9 percent). Within each class, scheduled rate increases will vary for specific mailing services. For example, the rates for Standard Mail Flats are scheduled to increase 0.9 percent, compared with a 3.4 percent increase for Standard Mail Letters. These variable increases reflect the Service's decision to moderate the increases for catalogs and other flats because of the large rate increases they experienced in May 2007. Furthermore, the Postal Service has recently notified the PRC of rate-

[19]According to the Plan, Intelligent Mail is a comprehensive term that describes the integration of electronic mailing documentation, intelligent mail barcodes, and scans to track mail at all points in the postal processing system.

[20]The major mail classes include First-Class Mail, Standard Mail, Periodicals, Package Service, and special services (e.g., Post Office boxes, Delivery Confirmation, and money orders).

setting initiatives for two of its competitive products. One notice pertained to establishing a premium for guaranteed delivery of Express Mail on Sunday and holidays, while the other notice pertained to establishing prices for a Priority Mail large-sized Flat Rate Box.

Continued congressional oversight will be needed of the Service's actions under the act to address its volume and revenue challenges. Particular attention should be paid to monitoring how the Service and mailers respond to a slowing economy and the implementation of the new rate process. Questions to address include the following:

- How will mailers and volume respond to changes in rates in the short term, as well as the Service's intent to fully use its pricing authority under the rate-setting cap? To what extent will these changes affect the mail mix, including the type, size, and weight of mail?
- What types of innovative pricing methods will the Service offer?
- To what extent will customers' desire for mail be affected by privacy concerns, environmental concerns, preference for electronic alternatives, or efforts at the state level to establish Do Not Mail lists?
- How will the Service be able to enhance the value of the mail (e.g., by providing more predictable and consistent service, tracking and tracing capabilities)?
- What will the Service do with any retained earnings (e.g., expand its capital program, save to weather downturns in the economy)?

Controlling Costs and Improving Operational Efficiency

The Service faces multiple pressures in the short and long term associated with controlling costs and improving productivity while experiencing above-inflation cost growth in certain categories, revenue challenges, and an inflation-based price cap. In the first quarter of 2008, the Service reported responding to revenue shortfalls by cutting more than $300 million in costs compared to plan, including reducing over 10.5 million workhours compared to the first quarter of 2007. The Service indicated that continued vigilance on cost will be needed for the rest of the year, and it will prove increasingly difficult to reduce workhours at the same pace if revenue challenges continue. The Postal Service budgeted for a $1 billion reduction in expenses for 2008, to be achieved in part by reducing 28 million workhours and increasing productivity by 1 percent. Based on the first quarter's performance, the Postal Service recognizes that it needs to

more aggressively reduce expenses to mitigate the financial impact of the economic slowdown, and it has identified an additional $1 billion in cost reduction efforts, many of which are tied to reduced volumes. While actions taken to implement the reform act put pressure on costs—the Service expects a net increase of $1 billion in costs in 2008—the act also eliminates other payments and provides opportunities to offset some of these cost pressures through efficiency gains that could restrain future rate increases. It will be crucial for the Service to take advantage of this opportunity and achieve sustainable, realizable cost reductions and productivity improvements throughout its networks.

Personnel expenses (which include wages, employee and retiree benefits, and workers' compensation) have consistently accounted for nearly 80 percent of annual operating expenses. Growth in such expenses has exceeded inflation in each of the last 4 years, and the expenses are budgeted to increase by almost $660 million in 2008. The major drivers of the personnel expense increase include cost of living adjustments (COLA), general wage increases, and health benefit expense increases. For example, retirement health benefit costs have tracked well above the rate of inflation, and will remain high because of the new multibillion dollar payments required by the law.

Another cost pressure the Service faces is to modernize and maintain its vast infrastructure and transportation system that supports its expanding delivery network—projected to increase by 1.9 million delivery points in 2008. The Service's transportation costs have grown faster than the rate of inflation for the past 3 years and were budgeted to increase by 5.4 percent ($350 million) in 2008. The Service attributes these increases in part to contractual rate increases and rising fuel costs. We noted the Service's vulnerabilities to rising fuel prices in a report issued last year.[21] We have also reported on the challenges facing the Service in managing its 34,000 facilities nationwide, including the need to capture and maintain accurate facility data, adequately maintain facilities, address deferred maintenance issues, and align retail access with customer needs.[22]

[21]GAO, *U.S. Postal Service: Vulnerability to Fluctuating Fuel Prices Requires Improved Tracking and Monitoring of Consumption Information*, GAO-07-244 (Washington, D.C.: Feb. 16, 2007).

[22]GAO, *U.S. Postal Service Facilities: Improvements in Data Would Strengthen Maintenance and Alignment of Access to Retail Services*, GAO-08-41 (Washington, D.C.: Dec. 10, 2007).

The act provides an opportunity for the Service to address its cost challenges by establishing an inflation-based price cap for market-dominant products, which provides an incentive for the Postal Service to operate more efficiently. The act also requires the Service to develop a plan by June 2008 that includes its strategy for rationalizing the postal facilities network and removing excess processing capacity from the network. As part of this plan, the Service is to identify cost savings and other benefits associated with network rationalization alternatives. This plan provides an opportunity for the Service to make its case that realignment is needed to address infrastructure issues (e.g., excess capacity, maintenance needs, and facility locations) and reduce costs. It can also address concerns raised by Congress and the public about how decisions related to planned network changes are made and communicated to affected parties. We have reported our concerns that the Service's strategy for realigning its processing and distribution network and workforce was not clear, and that its strategy lacked sufficient transparency and accountability, adequate stakeholder input, and performance measures for results and we have recommendations outstanding related to these concerns.[23]

The Service recognizes these cost challenges and plans to build on its progress in this area. We have reported on the Service's progress in containing cost growth by reducing workhours, downsizing its workforce and improving productivity, and the Service's ability to control cost growth during the first quarter was encouraging. Furthermore, the Service should benefit from agreeing with its four major labor unions reducing its future share of the contributions to the cost of health benefit premiums for many of its employees. The Service is planning to continue its cost cutting efforts as part of its Strategic Transformation Plan and is seeking efficiency gains from a variety of sources including

- more fully automating the sorting of flat mail—in 2008, the Service will deploy 100 machines to automate flat sorting in 30 to 35 facilities as part of its Phase One of the Flats Sequencing System (FSS);

[23]GAO, *U.S. Postal Service: Progress Made in Implementing Mail Processing Realignment Efforts, but Better Integration and Performance Measurement Still Needed,* GAO-07-1083T (Washington, D.C.: July 26, 2007); *U.S. Postal Service: The Service's Strategy for Realigning Its Mail Processing Infrastructure Lacks Clarity, Criteria, and Accountability,* GAO-05-261 (Washington, D.C.: Apr. 8, 2005); and *U.S. Postal Service: Mail Processing Realignment Efforts Under Way Need Better Integration and Explanation,* GAO-07-717 (Washington, D.C.: June 21, 2007).

- outsourcing certain activities, such as expanding contract delivery service;[24]
- consolidating mail processing operations;
- optimizing retail resources using two scheduling tools to help managers align staffing to changes in customer demand; and
- working with members of the mailing industry to optimize mailer preparation requirements, including the use of Intelligent Mail Barcodes on mailpieces, to facilitate achieving the lowest combined mailing cost for all parties.

Making progress in addressing cost challenges will be important as the Service is required to operate under the new price cap, particularly if the economy continues to weaken. Progress will also be needed in areas where it has been difficult to achieve. For example, we reported last summer that progress in consolidating mail processing operations among facilities has been slow due to several factors.[25] In some cases, the Service was not ready to proceed with the consolidation, and other external factors have slowed the process, including union and community resistance. In addition, language in recent Senate Appropriations Committee reports has directed the Service not to implement consolidation decisions in certain locations until specific requirements have been met.[26] Furthermore, in its first quarter financial report, the Service stated that if proposed legislation limiting its ability to contract out mail delivery and other postal activities is enacted, it would place significant restraints on its ability to achieve cost reductions. As actions are carried out to control costs in the future, continued oversight will be needed to ensure that the Service's cost reduction strategies achieve their goals, without negatively affecting service. Specific oversight questions include the following:

[24]We are currently performing work related to the Service's outsourcing activities and plan to issue a report this summer.

[25]GAO-07-717.

[26]Senate Report No.109-293, at 228 (2006) directed that consolidation decisions pertaining to three locations not be implemented until the Postal Service received a GAO report, which was completed in July 2007. Senate Report No. 110-129, at 108 (2007) directed the Postal Service not to implement certain Area Mail Processing Facility consolidations until the Postal Service fully implements GAO's recommendations from its July 2007 report an develops a mechanism to evaluate potential and actual impacts on delivery.

- If volume shortfalls persist, will the Service be able to implement corresponding cost controls?
- If the economy continues to worsen and/or certain key costs continue to increase at levels above inflation (e.g., health benefit costs), how can the Service still meet its service goals and manage its costs under the rate cap?
- How will the new rate structure lead to efficiency improvements throughout the mail system?
- Will the Service's implementation of its network realignment result in greater cost savings and improved efficiency?
- How do external constraints limit the Service's ability to achieve cost savings through network optimization and what can be done to alleviate these constraints?
- Would the Service achieve its expected return on investment and improvements in operational performance in a second phase of automated flat sorting equipment?

Managing Its Workforce

The Service will be challenged to manage its workforce as it transitions to operating in a new postal environment. The Service is one of the nation's largest employers, with almost 786,000 full- and part-time employees at the end of 2007. As the Service continues to improve its operational efficiencies (i.e., rationalize its facilities, expand service measurement, increase automation, improve retail access, and streamline its transportation network), it will be challenged to realign its workforce in accordance with these changes. These challenges may be compounded by such factors as (1) changes in mailers' behavior in response to the new rate structure and economic uncertainty that may reduce the level of processing needed at Postal Service facilities and (2) the expected retirement of a significant portion of its workforce, particularly at the executive level, within the next 5 years. These actions will require a different mix in the number, skills, and deployment of its employees, and may involve repositioning, retraining, outsourcing, and further reducing its workforce. The Service must describe, as part of the Facilities Plan required by the act, its long-term vision for realigning its workforce and how it intends to implement that vision. This plan is to include a discussion of what impact any facility changes may have on the postal workforce and whether the Postal Service has sufficient flexibility to make needed workforce changes.

The Service recognizes the challenges in aligning its workforce with changing customer needs, new technologies, and emerging markets. In its updated Strategic Transformation Plan, the Service includes specific actions aimed at improving workforce flexibility, succession planning, and staffing efficiency. As it takes actions in this area, oversight will be important in several areas including:

- How will the Service's workforce be affected by the implementation of new automation equipment that supports such initiatives as FSS or Intelligent Mail?
- How will the Service balance the varying needs of diverse customers when realigning its delivery and processing networks?
- How will employees and employee organizations be affected and informed of network changes and how will the Service monitor the workplace environment?
- How will the Service take advantage of flexibilities to deal with peak operating periods?

Maintaining, Measuring, and Reporting Service

The Service faces continued challenges in further updating its delivery performance standards, implementing representative measures of delivery performance, setting appropriate goals for delivery speed and reliability, and reporting results in a transparent and accessible manner. This information is critical for stakeholders to understand how the Service is fulfilling its mission of providing affordable, high-quality universal service on a self-financing basis—it would assist the Service and its customers in identifying and addressing delivery problems, and help Congress, the PRC, and others to hold management accountable for results and conduct independent oversight.

In July 2006, we reported that the Service's delivery performance standards, measurement, and reporting needed improvement.[27] Among other things, we found that delivery standards for major types of mail had not been updated in a number of years and did not reflect current operations, including how mail is prepared and delivered. We also found that the Service does not measure the delivery performance of most types

[27]GAO, *U.S. Postal Service: Delivery Performance Standards, Measurement, and Reporting Need Improvement*, GAO-06-733 (Washington, D.C.: July 27, 2006).

of mail, which limits transparency. Based on these and related findings, we recommended the Service take actions to modernize its delivery service standards, develop a complete set of delivery service measures, more effectively collaborate with mailers, and improve transparency by publicly disclosing delivery performance information.

The act provided an opportunity to address these issues by requiring the establishment of modern delivery standards, the setting of goals for these standards, and annual progress reports. The act also established other requirements:

- The Service must issue modern service standards by December 2007 (these standards were issued);
- Within 6 months of issuing service standards the Service must, in consultation with the PRC, develop and submit a plan, with performance goals, to Congress for meeting those standards.
- Within 90 days after the end of each fiscal year, the Service must report to PRC on the quality of service for each market-dominant product in terms of speed of delivery and reliability, as well as the degree of customer satisfaction with the service provided.

The act also identified four objectives for modern service standards:

- Enhance the value of postal services to both senders and recipients.
- Preserve regular and effective access to postal services in all communities, including those in rural areas or where post offices are not self-sustaining.
- Reasonably assure Postal Service customers delivery reliability, speed, and frequency consistent with reasonable rates and best business practices.
- Provide a system of objective external performance measurements for each market-dominant product as a basis for measurement of Postal Service performance.

The Postal Service has taken an active role to address this challenge, including collaborating with mailers and the PRC on issuing the new service standards. The Service submitted to the PRC a proposal on service measurement using Intelligent Mail and is planning to expand the geographic coverage of its External First-Class Measurement System, and the PRC has put this proposal out for comment. The Service is also consulting with the PRC about other reporting issues.

We are encouraged by the Service's progress to date as well as its performance during the first quarter of 2008 for the segment of First-Class Mail that it currently measures. The delivery performance for mail measured by the Service's EXFC system reported on-time deliveries for 96 percent of 1-day mail, 93 percent of 2-day mail, and 88 percent of 3-day mail, all of which were improvements over the first quarter of 2007. We continue to believe that the key principles of completeness, availability, and usefulness should guide future actions related to updating service standards and implementing performance measurement and reporting systems. Continued collaboration and oversight will be critical to making further progress as the system becomes more and more developed. In particular, questions will need to be asked, including the following:

- How should the standards and goals reflect different operational capabilities that affect the speed and reliability of delivery, such as presorting and separate processing streams?
- Given the different information needs of the various stakeholder groups—e.g., the Service, PRC, Congress, mailers, the American public—what are appropriate levels of transparency for each of the key groups?
  - What level of detail should be available to each group? For example, some mailers have said they need detailed, real-time information to help identify and address delivery problems.
  - In what format should information be available, and how should privacy be protected?
  - How frequently should information be reported and/or accessible (e.g., quarterly, annually, or in real-time)?
  - Should mailers pay for some of the information?
- How should mailer issues regarding the implementation of Intelligent Mail be addressed?
- What exclusions, if any, should be allowed under the Service's reporting of annual results (e.g., exclusions for the holiday mailing period and incorrectly addressed and/or prepared mail)?

Implementing New Regulatory Frameworks

The Postal Service and PRC will continue to be challenged to successfully implement the extensive regulatory changes required by the act. Currently, the PRC is reviewing the May 2008 rate increases filed by the Service and has asked for public comment on this filing. In addition to the PRC's regulatory responsibilities for rate setting and monitoring service performance discussed earlier, these parties will be challenged to implement other requirements related to postal costing, accounting, and financial reporting. We have reported on specific challenges the Postal Service has faced in these areas. With respect to its financial reporting, the Service has made significant improvements in the frequency, content, and availability to address our earlier recommendations.[28] Furthermore, in 2005 we reported on the long-standing issues of ratemaking data quality, many of which persist today.[29]

The act establishes new reporting and accounting requirements that should help to address these challenges. The major change is the establishment of, and authority provided to the new PRC to help enhance the collection and reporting of information on the Service's postal rates and financial performance. The PRC has oversight responsibilities in such areas as:

- Market-dominant products: The PRC must prescribe by regulation the form and content of annual Service reports that analyze costs, revenues, and rates, using methods that PRC must also prescribe; specify which reported information shall be made public; initiate proceedings as necessary to improve the quality, completeness, or accuracy of this information; and assess compliance and complaints.
- Competitive products: The PRC must establish regulations that ensure that each competitive product covers its attributable costs, prohibit the cross-subsidization of competitive products by market-dominant products, and ensure that competitive products collectively cover what PRC determines to be an appropriate share of the Service's institutional costs (overhead costs), as well as to assess complaints.

[28]GAO-07-684T; GAO-01-598T; GAO, *U.S. Postal Service: Deteriorating Financial Outlook Increases Need for Transformation*, GAO-02-355 (Washington, D.C.: Feb. 28, 2002); *U.S. Postal Service: Accounting for Postretirement Benefits*, GAO-02-916R (Washington, D.C.: Sept. 12, 2002); *U.S. Postal Service Actions to Improve Its Financial Reporting*, GAO-03-26R (Washington, D.C.: Nov. 13, 2002).

[29]GAO, *U.S. Postal Service: Improving Ratemaking Data Quality through Postal Service Actions and Postal Reform Legislation*, GAO-05-820 (Washington, D.C.: July 28, 2005).

- Financial reporting: The PRC must (1) review annual, quarterly, and other periodic reports from the Service that contains information required by the Securities and Exchange Commission (SEC) for registrants,[30] (2) review reports, due in 2010, on the Service's compliance with rules prescribed by the SEC for registrants in implementing section 404 of the Sarbanes-Oxley Act of 2002, and (3) by December 2008, establish the accounting principles and practices that the Service must follow related to its competitive products, and in doing so, consider Treasury recommendations.

The Service recognizes these challenges and the potential costs associated with meeting the new requirements. In its updated Strategic Transformation Plan, it laid out a timeline for implementing the Sarbanes-Oxley section 404 requirements and noted that it must manage the uncertainties related to the implementation of the new ratemaking process, the extent to which the PRC incorporates recommendations from the Treasury report, and any developments from the FTC report. The Service has not yet estimated the additional costs associated with these new regulatory requirements. We have reported that other federal agenc and smaller public companies have incurred significant costs associated with complying with SEC's implementing regulations for section 404 of the Sarbanes-Oxley Act, but have also reported that costs are expected to decline in subsequent years given the first-year investment in documenting internal controls.[31]

In sum, these changes can help provide accurate and timely data on the Service's costs, revenues, and mail volumes. This information can be used to enhance transparency and accountability for all postal stakeholders so that they have a comprehensive understanding of the Service's financial condition and outlook and of how postal rates are aligned with costs. As the new regulatory framework is implemented, continued oversight may be required in several areas:

[30]The Postal Service is deemed the "registrant" by the reform act; however, the Service is not a registrant for the purposes of submitting reports to the SEC.

[31]GAO, *Internal Control: Analysis of Joint Study on Estimating the Costs and Benefits of Rendering Opinions on Internal Control over Financial Reporting in the Federal Environment*, GAO-06-255R (Washington, D.C.: Sept. 6, 2006); *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, GAO-06-361 (Washington, D.C.: Apr. 13, 2006).

- How will the PRC use its discretion to continue defining and implementing the new regulatory structure?
- How effectively is the PRC carrying out its regulatory responsibilities regarding rate setting and monitoring service performance?
- Given the complexity of regulatory changes, how can the PRC balance the interests of all stakeholders, particularly those with less expertise and resources?
- What criteria will the PRC use for evaluating the quality, completeness, and accuracy of ratemaking data, including the underlying accounting data and additional data used to attribute costs and revenues to specific types of mail? Looking forward, how will the PRC, the Service, and other stakeholders consider and implement improvements to data quality over time?
- How will the PRC balance the need for high-quality ratemaking data with the time and expense involved in obtaining the data?
- How will PRC structure any proceedings to improve the quality of ratemaking data and enable the Service and others to participate in such proceedings? What proceedings might PRC initiate to address data quality deficiencies and issues that PRC has raised in its recent decision on the rate case?
- How will the Service be affected by the costs associated with complying with the SEC rules for implementing section 404 of the Sarbanes-Oxley Act, as well as the need for separate information on competitive and market-dominant products?

Required Information Can Guide Future Postal Reform Discussions

Information required under the act can be used to facilitate constructive dialogue and debate about postal reform issues related to universal service, the postal monopoly, fair competition, consumer protection, and transparency and accountability. Specifically, the act included provisions for reports required over the next 5 to 10 years related to key postal reform issues aimed at continually examining and reporting on the Postal Service's mission, role, and oversight structure in an increasingly competitive environment. The act required multiple stakeholders, including the Postal Service, PRC, Postal Service OIG, OPM, Treasury, and GAO, to issue these reports, and established a wide range of deadlines for this work. The information can be useful to Congress when it is considering key postal reform issues including:

- What universal postal service will be needed in the future and how should it be defined, given past changes and future challenges?
- To what extent should certain monopoly provisions be maintained or narrowed?
- What role should the Service play in providing universal postal services vis-à-vis its competitors?
- What are appropriate legal standards for fair competition in areas where the Service competes with private-sector providers?
- What transparency, oversight, and accountability are needed for the Service, particularly as long as it remains a federal entity with a monopoly to deliver letter mail?
- How appropriate are the new regulatory structure and rate-setting system?
- What barriers, if any, have prevented progress under the act (e.g., in optimizing the Service's infrastructure network), and how can they be addressed?

As outlined earlier, information related to some of these issues has already been published from the Treasury and FTC. Treasury issued a report on the accounting principles and practices that should be followed by the Service, and the FTC issued a report that analyzed laws that apply differently to the Service's competitive products and similar products provided by private competitors, and estimated the economic burdens on, and advantages to, the Service due to these legal differences. This information provides a good starting point for discussions on broader reform topics such as the following:

- Universal postal service and the postal monopoly: The mission of the Postal Service revolves around providing affordable, high-quality universal postal services on a self-financing basis. While the act requires the PRC to provide annual reviews of service quality and the estimated costs of providing universal service, the act requires a more comprehensive study from the PRC on the scope and standards of universal postal service and the postal monopoly. This report, due by December 2008, is to describe any deficiencies in universal service and can include recommendations on future changes. The PRC is required to obtain public comments and consult with the Service in preparing this report.

- Accounting, financial transparency, and oversight: The PRC solicited public comments on Treasury's report. In addition, the PRC raised questions about what financial transparency and oversight are appropriate for the Service's competitive products fund and whether a public or private entity should conduct such oversight. These comments will assist the PRC in fulfilling the act's requirement to establish accounting practices and principles for the Service to follow, and issue regulations for the Service's reporting of its costs, revenue, rates, and volumes.

- Regulation of postal rates: The act requires the PRC to annually report to the President and Congress on the extent to which postal regulations, including those related to postal rates, achieve statutory objectives. Looking forward, the PRC is required to assess ratemaking and other provisions of the act every 5 years (with the first report due by December 2011), and review the system for regulating the rates and classes for market-dominant products by December 2016. At that point, the act empowers PRC to make changes to the system for regulating market-dominant rates.

- Future business model: GAO is required to issue a report by December 2011 that evaluates various options and strategies for the long-term structural and operational reforms of the Service. The requirement states that we may include, among other things, recommendations on how the Service's business model can be maintained or transformed to assure continued availability of affordable universal postal service.

We are encouraged by the early implementation steps that the Service, the PRC, the Department of the Treasury, FTC, and other stakeholders have taken. The Service, the PRC, mailers, and other stakeholders have found new ways to engage in constructive dialogue and debate and in some cases, reach consensus on how best to proceed. These actions—which contrast sharply with the adversarial ratemaking process abolished by the act—hold promise for future progress across a broad range of postal reform issues. Such progress will remain necessary as the Service, the mailing industry, and competitors transform themselves in response to the rapidly changing communications and delivery marketplace.

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

Contact and Acknowledgment

For further information regarding this statement, please contact Katherine Siggerud, Director, Physical Infrastructure Issues, at (202) 512-2834 or at siggerudk@gao.gov. Individuals making key contributions to this statement included Teresa Anderson, Joshua Bartzen, Kenneth John, Summer Lingard, Jeanette Franzel, Shirley Abel, Scott McNulty, Brandon Haller, David Hooper and Kathy Gilhooly.

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Mr. DAVIS OF ILLINOIS. Thank you very much, Ms. Siggerud.

Let me ask you how well would you say or what is your impression of how well the Postal Service and the Postal Regulatory Commission have been implementing the Postal Accountability and Enhancement Act?

Ms. SIGGERUD. Mr. Chairman, as I think you can tell from my statement, we have a generally good outlook on those issues. Just a couple examples, developing these new regulations was very complex, particularly with regard to rate setting and the efforts that were done to modernize the standards. Both of those were carried out in the collaborative and open fashion. And in the case of the rate setting framework, the deadline was met ahead of time, allowing the Postal Service to have a new rate proposal under the new system.

The key deadlines have been met not only by the Postal Service and the PRC but by several other key stakeholders that were also required to report to the Congress in the last year. I think there are a couple of areas for oversight that I mentioned in my statement, including with regard to looking at mail volumes and revenues and clearing this economic situation that we are in will be a concern over the coming year.

Mr. DAVIS OF ILLINOIS. We continue to hear rumbles of economic slowdown, recession, some places depression, shaky outlook for the economic future. How well would you say that the Postal Service is positioned to handle a slowdown or a downturn in terms of the movement of communication devices.

Ms. SIGGERUD. That's an excellent question. I think it is worth thinking about that question in a long and a short-term point of view. From the short-term point of view, clearly the Postal Service is suffering from lower than expected volumes. This is a direct result of problems in the financial services sector and other sectors as related to housing and credit. It is really impossible to know how long this will last.

Volumes are also affected by two other longer term issues, one being the electronic diversion issue. There are also the effects of last summer's rate increase in which the Postal Service gave incentives to mailers to prepare mail in a way that is cost effective for the Postal Service. Mailers are responding by changing the nature and the volume of their mailings.

The Postal Service also faces some significant cost issues. Fuel prices come to mind based on recent news and the data from last year for the Postal Service. There are also a core list of employees that must be made under the collective bargaining agreements. Short-term the Postal Service will be able to reduce its work hours since they are partly driven by volume, but that is not going to be a successful long-term strategy in terms of responding to volume decreases.

The good news is that in the first quarter of this year we began to see these issues happen. The Postal Service was able to cut costs, reduce work hours and also provide record service in the portion of the first class mail that it measures and reports. So there are both short-term solutions, long-term solutions. Short-term solutions involve work hours, looking at overtime, looking at transpor-

tation costs, as well as the fact that there will be new revenue in May.

Long term what the Postal Service needs to do is use the flexibility given to it in the act to develop and refine its products and services to attract increased volume and revenue. It also needs to improve productivity and efficiency. The flat sorting machines that are coming into place have some promise in that area. The data that will come out of the implementation of the intelligent mail bar code should also help the Postal Service to improve its management.

And finally, it does have the opportunity to try to remove some excess capacity from its networks in the long run.

Mr. DAVIS OF ILLINOIS. And so you think that there is room for increased proficiency?

Ms. SIGGERUD. Absolutely, I'm sure the Postmaster General would agree with me on that issue. And that is part of the reason the Postal Service is going with investments in automation.

Mr. DAVIS OF ILLINOIS. Thank you very much.

Representative Norton.

Ms. NORTON. Thank you very much for your testimony. Could I ask you how you think—you say in your testimony that the ongoing economic problems of the Postal Service are exacerbated by, you say, a projected $600 million net loss for 2008. How do you expect the Postal Service to meet the problems caused by this loss or to carry this loss?

Ms. SIGGERUD. Well, the Postal Service did project a loss. It is not a surprise to anyone. The economic situation may make the situation worse. The Postal Service does have a variety of short-term cost cutting efforts that may help to deal with that. The Postal Service is also allowed to borrow money, and in fact it will be increasing its debt at the end of the year as well. But going back to my response to the chairman, I think using the flexibility——

Ms. NORTON. Increase its debt?

Ms. SIGGERUD. Yes.

Ms. NORTON. In order to—what kind of bond rating does it have?

Ms. SIGGERUD. I do not know the bond rating on that, Ms. Norton. The Postal Service does have a cap on the total amount of debt that it can carry as well as the amount it can accrue each year.

Ms. NORTON. But you are saying increase debt in order to deal with loss?

Ms. SIGGERUD. It also was using debt to make capital investments.

Ms. NORTON. Yeah. It carries a loss over from year to year. How much—are these losses annual, have they been of this magnitude for some years now?

Ms. SIGGERUD. The losses actually are largely due at this point to the fact that the Postal Service is complying with the Postal Accountability and Enhancement Act's requirement to pay into retiree benefit funds. That will continue to be true for 9 years, 8 or 9 years following this year. That will continue to be a heavy lift for the Postal Service. It does have plans, however, to try to continue to grow revenue and reduce cost in order to deal with that situation.

Ms. NORTON. You mentioned an obvious terrible problem that any business like the Postal Service has, and that is dealing with fuel costs.

Ms. SIGGERUD. Right.

Ms. NORTON. Is the Postal Service as it purchases new vehicles, which it must have to do very often, converting to hybrid vehicles or the like?

Ms. SIGGERUD. This is an interesting question. We did some work on this very question last year and reported out in February the Postal Service has a number of different approaches to try to save fuel. But with regard to the vehicles, under the previous Energy Act, it was required to primarily purchase alternative fuel or flex fuel vehicles.

My understanding is under newer legislation the Postal Service is able to go in the direction of purchasing hybrids, which it expects to have better payoff in terms of fuel efficiency.

Ms. NORTON. What alternative fuel, what kinds of—biofuel?

Ms. SIGGERUD. The flex fuel vehicles of course typically run on ethanol when they are not running on gasoline.

Ms. NORTON. So you're saying that—I guess you're saying the new Energy Act we passed just a few months ago enables them to use any kind of alternative fuel or alternative——

Ms. SIGGERUD. Ms. Norton, I would like to provide the details for the record, but as I understand it, all the entire Federal fleet, including the Postal Service, has more flexibility under that act to look for the most fuel efficient vehicles that it can use rather than being required to purchase flex fuel vehicles.

Ms. NORTON. Well, the obvious thing you can do, without having to do a whole lot, certainly would be to—I have great problems with ethanol, when you consider what's happening to the price of grain. I understand where that comes from because there are parts of the country for which that is important.

Ms. SIGGERUD. Yes.

Ms. NORTON. But I think I would appreciate your providing us, and if you would provide me as well, with this information.

Ms. SIGGERUD. Absolutely.

Ms. NORTON. As an obvious way to cut costs. We are sure it will continue to rise. Thank you, Mr. Chairman.

Mr. DAVIS OF ILLINOIS. Thank you very much.

While we are setting up for our third panel, which will consist of Mr. John Potter, the postmaster general; the Honorable James Bilbray, member of the Board of Governors of the U.S. Postal Service; and of course Mr. Dan Blair, chairman, Postal Regulatory Commission, confirmed on December 9, 2006 by the U.S. Senate and designated chairman by President George W. Bush on December 15, 2006.

Gentleman, as you know, it is the custom and tradition to swear witnesses in so if you would stand and raise your right hands.

[Witnesses sworn.]

Mr. DAVIS OF ILLINOIS. The record will show that the witnesses answered in the affirmative.

Gentlemen, we thank you all so much for being here. And of course it is indeed a pleasure to see you, Mr. Bilbray, again and welcome. All of your statements are included in the record. If you

would take 5 minutes and summarize your statements, we would appreciate that. We begin with you, Mr. Postmaster General, Mr. Potter.

STATEMENTS OF JOHN E. POTTER, POSTMASTER GENERAL/CEO, U.S. POSTAL SERVICE; JAMES H. BILBRAY, MEMBER, BOARD OF GOVERNORS, U.S. POSTAL SERVICE; AND DAN G. BLAIR, CHAIRMAN, POSTAL REGULATORY COMMISSION

STATEMENT OF JOHN E. POTTER

Mr. POTTER. Thank you, Chairman Davis, and good afternoon. I am pleased to report to you today on the Postal Service's first year of operation under the Postal Act of 2006. The new law creates welcome pricing flexibilities that can and will benefit the Nation by keeping now a welcome, efficient and effective method to link every household and every business in America.

A financially healthy mailing industry based on a financially sound Postal Service supports local, regional and national economies. But with a growing network that reaches 148 million homes and businesses every day, the mail business is extremely sensitive to fluctuations in the economy, and to changes in the consumer preference of hard copy or electronic communication. The new law, for all its benefits, does not exempt the Postal Service from these facts.

Compounding the diversion of some mail to the Internet, we have been hard hit by today's underperforming economy. The financial credit and housing sectors are key drivers of the mail business. The recessionary trend in these industries was quickly reflected in declines in mail volumes and revenues. By the end of the first quarter mail volume was down 3 percent from a year earlier. First class mail fell by almost 1 billion pieces, or 4 percent. Standard mail fell by some 750 million pieces, 2.6 percent. Less mail volume means higher costs per piece of mail handled. Revenue was $525 million below plan and net income fell short by $83 million. We see no improvements this quarter.

Facing this extremely difficult situation, the men and women of the U.S. Postal Service have stepped up. They brought down spending, narrowing the huge revenue gap created by the sudden steep volume decline. Faced with a possible $2 billion shortfall this year, we are cutting $1 billion in costs on top of the 1 billion that was already built into our plan, but not at the cost of service. Despite quarter one's challenges, our people delivered the strongest service in our history. On-time delivery of next day first class mail reached 96 percent, our 2-day mail rose to 93 percent, an all-time high. Our 3-day matched our all-time high of 88 percent. We saw similar gains with remittance mail, payments to payments and credit card companies. Performance here is measured in hours, not days. And we cut 2 hours from payment processing and delivery between April and October, an all-time best.

We have a lot going for us the third straight time. We have been rated the most trusted government agency and one of the 10 most trusted organizations in the Nation. Customer satisfaction remains high at 92 percent. Americans view the Postal Service more favorably than any other government agency and have done so for the

past 10 years. Our brand is sound and our business is well positioned to rebound with the economy, but we cannot simply wait for a recovery, we must also pursue aggressive revenue growth.

On May 12th, we are addressing prices for our market dominant products, first class mail, standard mail, periodicals and package services. Under the law's new simplified pricing regulations and conforming to the CPI price cap, this can produce $735 million in additional revenue this year. To close the remaining gap, we are pursuing growth opportunities to a new and innovative price structure for competitive products. We will make these products more attractive through incentives and enhanced features. We will be announcing the prices shortly for a May 12th implementation.

Our people are ready. They understand the challenge and are ready to take up every new tool the law provided us. I am particularly gratified by the support of our unions in this area. With their help our employees are aggressively talking up and selling our products. They are making sure customers know how the mail can work for them. Every employee in the Postal Service understands that growth is necessary to produce the revenue and to support our mission of serving America, and every employee is part of that effort.

Over the past year other agencies in the mailing community have also been a part of the focused efforts to implement the requirements of the new law. Together our progress has been significant. We have adjusted workers' compensation procedures. We reported on the issue of commercial best practices in our purchasing regulations. We revised our policies on handling data in connection with legal and judicial activities. The Office of the Inspector General reported on the progress of our employee safety program. We created a plan for implementation of international customs requirements throughout our system. We developed and submitted our initial mail classification schedule to the Postal Regulatory Commission.

A report by the Office of Inspector General examined our assessment and appeals process for nonprofit mailings. The Treasury Department submitted its recommendations on separate accounting for our market dominant and competitive products. The Government Accountability Office published an internal report on the Postal Service and mailing industry recycling. We submitted the initial version of our annual compliance report to the PRC. We have made steady progress in compliance with the Sarbanes-Oxley Act requirements in the law, including the first quarterly filing of our 10-Q report.

A study by the Federal Trade Commission found that the Postal Service's status as a government agency provides us with a net competitive disadvantage versus private carriers. With the cooperation feedback and creative ideas of every part of the mailing industry, we created modern service standards for our market dominant products. I appreciate their help. With their input and consultation with the Postal Regulatory Commission, we have also begun work on new service measurement systems. Perhaps, most importantly, PRC issued its new price regulations well ahead of schedule.

I want to thank Chairman Dan Blair, his fellow commissioners and their staff for moving so quickly on this very, very important

issue. All of these important tasks required community-wide cooperation. I'm grateful for everyone's assistance.

Beyond the specific requirements of the law, we are also changing how we speak about our business so it is clear to our customers. We no longer talk about rates, we talk about prices. We no longer talk about negotiated service agreements, we are talking about contract pricing, and referring to market dominant products as mailing services and to competitive products as shipping services. We are entering a period of profound change. Through the new postal law you have provided us with a new ability to navigate that change.

As we begin this journey, I am grateful for your continual support of a sound and financially independent Postal Service that can serve our Nation long into the future.

I will be pleased to answer any questions. Thank you, Mr. Chairman.

[The prepared statement of Mr. Potter follows:]

UNITED STATES
POSTAL SERVICE

STATEMENT OF
POSTMASTER GENERAL/CEO
JOHN E. POTTER
BEFORE THE
SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE,
AND THE DISTRICT OF COLUMBIA
OF THE
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES
WASHINGTON, DC

FEBRUARY 28, 2008

Good afternoon, Chairman Davis, Congressman Marchant, and members of the Subcommittee. I am pleased to have the opportunity to report to you today on the status of the United States Postal Service as we work with our employees, with our customers, and with other agencies of the federal government to implement the provisions of the Postal Act of 2006.

In testimony before this Subcommittee last year, I discussed the fundamental changes the new law brings to the operation of the Postal Service. These fall into three primary areas: the division of our business into market-dominant and competitive products; new, flexible, and different pricing systems for each of these product groups; and the replacement of a break-even financial requirement with one that permits retained earnings or, simply put, profit.

I believed then, as I believe now, that the new law offers the Postal Service tremendous opportunities. I believe that these opportunities can and will benefit every user of the mail, from the consumer to the small business to each and every part of the world's most advanced and innovative mailing industry – the organizations that rely on the mail as a welcome, efficient, and cost-effective method to connect with their business partners and customers.

Their success is an engine that creates employment, produces and invests revenue, funds the operation of government at every level, and supports local, regional, and national economies – both directly and through closely linked supply chains.

With a network that is – and must remain – capable of reaching 148 million delivery addresses every day – a delivery base that expands by some two million each year – America's postal system is extremely sensitive to fluctuations in the economy, both as they affect us and as they affect mail users.

We are now almost halfway through our first full fiscal year of operation under the new law. In addition to the $5 billion net loss we incurred last year as a result of the transition to the pre-funding of our retiree health benefits obligation, we are facing a potential net loss of over $1 billion this fiscal year. Later in my testimony, I will discuss how we are addressing this challenge.

It is reasonable to ask "how did we get here?" Just one year ago, the Postal Service was developing plans that would build on our successes and take advantage of the new approaches defined by the new law. We had just completed a year marked by record mail volume – more than 213 billion pieces, reflecting the robust condition of the economy. Service was strong. We were preparing to adjust our prices in May to offset a sharp surge in energy and other costs, and to provide incentives for mailers to shift volume to shapes and sizes that our system can process more efficiently. As it had since the Postal Service supplanted the heavily-subsidized Post Office Department in 1971, the average price of a stamp would continue to track inflation.

While a price change often results in short-term mail volume declines, volume returns to – and generally surpasses – previous levels relatively quickly. This was not the case as we ended fiscal year 2007 and moved into fiscal year 2008.

As the pace of economic growth began to slow down late in 2007, mailers compensated by adopting these incentives quicker than our plans had anticipated, negatively affecting our revenue projections.

In some ways, the current weak economy has disproportionately affected Postal Service revenue. The financial, credit, and housing sectors are among the key drivers of our business. With recessionary trends in these normally strong sectors, mail volume and revenue began a strong and steady decline. As we approach the mid-point of our fiscal year, we see deterioration continuing, with no signs of improvement.

Tighter credit means less credit prospecting, with offers of credit far more limited than previously. Consumer confidence is down. The recent holiday season registered the weakest retail sales since 2002. And with reduced consumer spending, there is less demand for shipping.

The problems in the mortgage and housing markets have resulted in a slowdown of new construction and a surplus of unsold new homes. With fewer new households, there is less growth opportunity for catalogs, magazines, and other mail.

Since the widespread adoption of the Internet and other electronic communications, their functionality has moved from informational to transactional. This has resulted in a steady erosion of First-Class mail, historically our most profitable product. As the current economic conditions place added pressure on profit margins, we are seeing a growing number of businesses offer incentives and add new charges to increase the rate of conversion to electronic bill presentment and payment.

This has driven a shift in mail usage. Today, Standard Mail – largely catalogs, advertisements, and offers – has supplanted First-Class Mail as our largest product. This has made us far more sensitive to downturns in the economic cycle, as advertising spending is extremely vulnerable to periods of retrenchment. And, while advertising alternatives may not offer mail's advantages, particularly in terms of targeting, personalization, or effectiveness, there are signs that advertisers and marketers are shifting a portion of their spending to lower-cost electronic media.

During previous slumps, we could expect advertisers to return to the mail as the economy improved. However, because electronic channels were not available in the past, we expect that some mailers will shift a portion of their spending permanently to these lower-cost media, contributing to the ongoing structural change in mail usage.

We are also facing "Do Not Mail" legislative initiatives in some 15 States. These not only threaten the viability of the mail in and among the affected states; they also undermine our ability to support a national network, one capable of serving every resident of every state, territory, and possession – affordably, effectively, and efficiently. We believe the success of these initiatives will also come at the expense of jobs, the viability of local businesses, and the reduction in municipal, county, and state revenue. We cannot afford these results during the best of times; they are unthinkable when the economy is faltering.

These conditions have had a material and negative effect on our bottom line. Our first quarter, which coincides with the historically busy holiday mailing season, did not record any volume growth. In fact, it was the first time that holiday mail volume was less than that of the previous year.

Overall, mail volume declined by 3 percent, with virtually every product category down. As a result, our revenue was $523 million below plan. Net income fell short of our expectations by $183 million.

First-Class Mail, our largest revenue producer, fell by almost 1 billion pieces, some 4 percent below the same period last year. Standard Mail, which eclipsed First-Class Mail as our largest volume product in 2005, declined by almost 750 million pieces, 2.6 percent less than the first quarter of 2007. There are no current signs of improvement for quarter 2.

Ultimately, less mail volume results in less revenue to support infrastructure. That means higher costs per piece of mail handled. Our fixed delivery costs are the same for bringing one piece of mail to your door as they are for twenty. As the only delivery service provider with a universal service obligation, we cannot offset costs by offsetting service levels.

Our mission is to provide uniform service at a uniform price to everyone, everywhere, every day. This mission does not change, whether the economy is growing or declining. And, because Postal Service operations are not dependent on tax dollars – they are funded by the sale of our products and services – we must carefully manage costs and pursue profitable growth opportunities to maintain the reach and effectiveness of the nation's postal system.
Cost cutting alone will not help us achieve prosperity. Rather, it risks undermining service levels. This, in turn, would diminish confidence in our brand, not only limiting growth opportunities but driving customers to other channels and competitors.

As we faced the fiscal realities of an extremely difficult first quarter, we could not lose sight of these issues. I am pleased to say that the men and women of the Postal Service were up to the challenge. For more than 230 years – during good times and bad – they have demonstrated their grit, professionalism, and commitment to service. The last several months have been no exception.

With less mail coming in, they realigned resources, quickly bringing down spending. They adjusted transportation to match volume. They reduced expenditures for supplies, services, and other non-personnel expenses. They used less overtime and increased the use of seasonal employees, consistent with the provisions of our labor agreements. While they did bring spending considerably below plan, even these reductions could not close the huge revenue gap created by the sudden, steep, and ongoing decline in mail volume.

Those important operational decisions, made in the field and at national headquarters, went beyond the simple exigencies of quarterly financial results. They were also focused on longer term needs. Our people understood that our financial challenges existed separate and apart from customer expectations. If we were not meeting or exceeding those expectations, we risked having customers take their business elsewhere. Only by protecting service – even as we cut costs – could we create an environment that will support growth when the economy begins to recover.

The good news is that we not only met customer expectations, but from a service perspective, we had the strongest first quarter in our history. This is traditionally our most difficult quarter, coinciding with the onset of severe winter weather and the pressures of the holiday mailing season. Independently measured on-time delivery of single-piece First-Class Mail committed for next-day delivery reached 96 percent, two-day mail rose to a record 93 percent, and three-day mail held at a first-quarter high of 88 percent. Two of our 80 field districts achieved an overnight on-time rate of 98 percent; another five scored a 97 percent.

We saw similar progress with remittance mail – largely payments to banks and credit card companies. Bill payments are so time-sensitive that mailers measure our performance in hours, not days. The latest report from Phoenix-Hecht – prepared by the industry for the industry – shows that we reduced two hours from our payment processing and delivery time since the last report, just six months ago. With an economy defined in part by credit problems, delivery speed means more than ever for these customers. Every extra hour they have access to their payments makes a difference to them.

It makes a difference to us, as well. Our speed in delivering these payments, combined with the extraordinary levels of trust Americans have in the mail, can keep us competitive in this market.

In 2007, for the third time in a row, the respected Ponemon Institute has rated the Postal Service as the most trusted government agency and one of the ten most-trusted organizations in the nation – public or private.

This is an extremely important differentiator as consumer concerns about identify theft continue to grow. Amid these concerns, new data collected by the Federal Trade Commission confirm that although there are many sources of identity theft, the mail is, by far, one of the least significant. Only two percent of those surveyed identify the mail as a source of this crime. This reflects the vigilance and effectiveness of the Postal Inspection Service in bringing perpetrators to justice, in serving as a deterrent through their effective investigations, and in participating in education and awareness programs that help consumers protect themselves.

It should come as no surprise that customer satisfaction with the mail remains extremely high – among the highest of many consumer products and services. Ninety-two percent of residential customers rate their experience with the Postal Service as excellent, very good, or good.

These results, also independently measured, were echoed in a recent Roper Poll showing that the American people view their Postal Service more favorably than any other federal agency rated – with almost half reporting that they view us "very favorably". We have held this top position for ten years.

As we reach out to serve the world's markets, we are pleased that by the end of fiscal year 2007, each of our five International Service Centers – in Chicago, New York, San Francisco, Los Angeles, and Miami – received the Certificate of Excellence awarded by the International Post Corporation. These facilities serve as our primary hubs for international mail. The certification is the result of a rigorous, 140-step evaluation process to identify facilities that have achieved the highest standard of mail processing efficiency. The United States Postal Service was the first to be recognized with certification for each of its international facilities.

Not only did our employees deliver the best service ever during 2007, they also made it our safest year, with continuing declines in industrial and motor vehicle accidents. We have developed effective partnerships and agreements with our four major unions and with the Occupational Safety and Health Administration, and they are improving workplace safety. The direct beneficiaries are our employees and their families.

The Postal Service also offers access no other business can match. With 37,000 postal facilities, our retail network is the largest in the nation. More than 45,000 retail partners make postage stamps as convenient as a trip to the supermarket, drug, greeting card, or convenience store. Each of our 77,000 rural delivery routes serves as a Post Office on wheels. Our carriers will pick up packages and mail at your home, your business, and at more than 300,000 blue collection boxes. And just about everything you can do at the Post Office, you can do online, at our website, usps.com – it's the Post Office that never closes.

While our brand is sound and our business, in many ways, is well-positioned to rebound with the economy, even the experts are unsure about the duration or ultimate extent of the current downturn. We are encouraged by the actions of Congress, the White House, and the Federal Reserve in working to strengthen the economy. We believe that a successful stimulus package can create the necessary conditions that will stabilize and contribute to reversing current mail-volume trends.

However, we cannot simply wait for a recovery. We must act now to pursue the strategies that will help us close this year's budget gap. We cannot afford – literally or figuratively – to begin the first year under a price cap system more than $1 billion in the red. We would never be able to dig out of that hole. To avoid this, we are following a two-part strategy: prudent cost management and focused revenue growth.

We have closely reviewed all of our costs and the immediate opportunities for efficiency improvements – at every level of the organization and in operational and administrative functions. We have identified savings of an additional $1 billion dollars over the $1 billion already built into our budget. Our leadership has made a commitment to achieve every penny of the savings identified in their areas. We will meet this goal. And we are clear in our resolve that it will not come at the expense of service.

Just as importantly, the active pursuit of growth must be – and has become – an integral element of our business. We are long past the time when we could expect steady, year-after-year mail volume growth to produce the revenue necessary to pay for a continually expanding network – one that links every family and business in the nation with every other.

The market in which we operate continues to grow more competitive. This means that the Postal Service must become more flexible if it is to remain competitive and successfully meet its obligations to the nation. The Postal Act of 2006 provides us with new tools that are intended to help us do this. This includes new approaches to pricing, intended to foster revenue growth.

Throughout the entire Postal Service, employees recognize that the new law has fundamentally changed the way we do business. They know that revenue growth and profit are necessary to a secure future. They understand that their success is dependent on the organization's success. They realize that operational excellence and customer focus go hand in hand. It cannot be one or the other. It must be both.

Our first full year of operation under the provisions of the new law is also the first year of new, multi-year, collective-bargaining agreements with each of our four major unions. This is the first time in a generation that the new agreements have become effective at virtually the same time. This puts all of us on the same starting line, at the same time, prepared to face a challenging new world together.

I appreciate the recent dialogue I have had with union leadership about opportunities for growth and ideas on employee efforts to fully educate our customers on our services. I also have shared with our unions the concepts behind our pricing strategies and sought their input, which has been helpful and valued. Despite this, there are issues such as contracting where differences remain. We are engaged in a constructive dialogue to discuss with the unions possible options regarding delivery services and the processing network.

I am, however, encouraged that the unions and management are in agreement on some of the key issues that are facing us. There is unanimity on the need for growth. There is unanimity on the fact that all of our employees, whatever their jobs, have a role in driving that growth. I am particularly grateful to the presidents of the American Postal Workers Union, the National Association of Letter Carriers, the National Postal Mail Handlers Union, and the National Rural Letter Carriers' Association for their support, encouragement, and ideas in this area.

Our entire team is ready to make the new law work for us and for our nation. We are acting quickly to use its new approaches to produce the revenue that can close the remaining $1 billion of our budget gap. Even though the new law permitted us one final price-adjustment cycle under the provisions of the 1970 law, the inordinate length of that process would not have produced additional revenue before the middle of our next fiscal year. Frankly, we could not afford that.

Neither could our mailers. In our conversations with them, they made it clear their preference was for smaller, regular, and more predictable price changes. This allows them to better plan and budget for mailing expenses, avoiding the "sticker shock" many of them experience when they must absorb larger price increases every two or three years. Consistent with the intention of the new law, we plan to adjust rates each May.

Our decision to adjust rates on May 12 for our market-dominant products – First-Class Mail, Standard Mail, Periodicals, and Package Service – is projected to produce about $735 million in additional revenue through the end of this fiscal year. Prices for these products will increase by an average of 2.9 percent at the class level, conforming to the law's requirement that they not exceed the rate of inflation as measured by the Consumer Price Index.

In some service categories, prices will remain the same or will actually go down. For example, there is no change in the additional-ounce rate for single-piece First-Class Mail. There is a new, lower additional-ounce price for some presorted First-Class letters. The pound price for Standard Mail saturation and high-density flats will be lower than the current rates. And through the new price structure, we have continued to simplify our international services, aligning them more closely with domestic products, making it easier for customers to select the prices and services that best meet their needs.

The law requires the Postal Service to operate in a more businesslike way than had been possible under the restrictive provisions of the old law. We recognize that pricing innovation – even within the limits of a well-defined rate cap – is a key business driver. With that in mind, we are taking full advantage of our new pricing flexibility to grow business.

We could not have acted so quickly without the diligence of the Postal Regulatory Commission and its Chairman, Dan Blair. Although the law did not call for the Commission to develop new pricing regulations before June 2008, its members made this a priority and worked closely with the mailing community to understand its needs and preferences.

The Commission's completion of this complex and critical task in October, well ahead of schedule, put the Postal Service in a better position to weigh its needs against the new and the old pricing regulations, permitting us to make a decision that will have a significant and positive impact on our bottom line in the current fiscal year.

Taken together, the additional cost reductions of $1 billion, combined with the $735 million in increased revenue from the coming price adjustment, can reduce our projected 2008 loss from $2 billion to $265 million.

We have taken a realistic look at immediate-term growth opportunities, both in core, market-dominant products, and in competitive products – such as Express Mail, Priority Mail, and Parcel Select. We believe that over the next seven months we can and we will exceed the revenue that will be produced by the coming price adjustment and more than meet the $1 billion we have added to our revenue target.

We are now finalizing a new price structure for our competitive products category and expect to announce it sometime next month. Unlike market-dominant products, prices in this category are

not linked to the CPI cap and can be aligned more closely with the needs of customers and the dynamics of the marketplace.

In the meantime, we are enhancing our Express Mail and Priority Mail products so they provide even greater customer value. We are expanding the range of the Express Mail guaranteed overnight network to include even more ZIP Code destinations. We are providing additional scanning as Express Mail moves through the network, providing customers with the enhanced tracking information they are requesting.

Unlike similar products offered by competitors, Express Mail offers Saturday delivery at the regular weekday delivery price. And the Postal Service is alone in offering Sunday and holiday delivery of this guaranteed overnight delivery service. The new premium pricing – which matches other shippers Saturday delivery surcharges – reflects the premium delivery option the Postal Service provides on Sundays and holidays. These are services that are not available from other providers at any price.

Responding to the needs of commercial shippers, we have introduced a new, larger Priority Mail Flat-Rate box. We have also made it easier for friends and families to bring a touch of home to their loved ones serving at overseas military addresses with a two-dollar lower price on the new Flat-Rate box. This is a first, something that was not possible under our previous pricing regulations.

We have just scratched the surface of the advantages the new law offers through its new approach to price setting. I have challenged everyone in the organization to bring their ideas to the table. They are responding with energy, with creativity, and with a commitment to making our services the services of choice for every mailer and every shipper.

Our preparations over the last year have also included addressing the multiple new review, policy, and reporting requirements established by the law. Some were the sole responsibility of the Postal Service. For others, we provided cooperation and assistance to the agencies that were assigned primary responsibility.

Soon after the law's enactment, we instituted a new nationwide policy to implement the changes it mandated to the workers' compensation program for employees.

By early spring, we had completed a review and assessment of our existing purchasing regulations. We found that they met the intent of the law as it relates to the use of commercial best practices and fair treatment of suppliers. The law recognizes the positive business value of these approaches to purchasing the supplies and services that support a nationwide mail processing, transportation, and delivery network. Through innovative practices such as national pricing agreements and reverse auctions, we can seek the best value – a combination of price, quality, availability, and service. This helps minimize our costs and limits growth in the price of postage, ultimately benefiting every postal customer in every community. Last year, using these approached, our cost for supplies and services – at $2.6 billion – was $49 million less than the previous year.

Another issue we examined last year was the retention, handling, and release of data that may be relevant to legal and judicial activities. As a result we developed data retention policies that are now standard throughout the organization. These are supported by well-defined procedures that we will follow in response to subpoenas.

The independent Office of Inspector General of the Postal Service submitted its report on workplace safety to the President, Congress, and to Postal Service management. We were extremely pleased by its conclusion that ". . . the Postal Service established and exceeded its OSHA I&I (Injury and Illness) reduction goals . . . ." In November, we provided Congress with our response to this report.

We also reviewed our international operations from the perspective of customs practices. As a result, we have created a plan for the effective implementation of customs requirements throughout the system.

By September, we developed and submitted our initial Mail Classification Schedule to the Postal Regulatory Commission. This was a critical step in the delineation of the distinctions between our market-dominant and competitive products categories.

The requirement that the Postal Service develop modern service standards and the supporting service measurement systems for market-dominant products is among the most far-reaching activities called for in the new law. By November, we provided the Postal Regulatory Commission with an outline of our approach to service measurement, beginning an important conversation on this subject. In December, after months of consultation with the Commission, we published our modern service standards.

The new standards take into account the current capabilities of our mail processing and transportation networks, as well as changes in mailer behavior – such as worksharing and entering mail deeper into the postal system – that can have a material effect on the amount of elapsed time from mailing through delivery. The input of mailers representing virtually every element of the mailing community was an ongoing and integral part of this process. This cooperative effort contributed to the development of service standards that meet the needs of customers as well as the Postal Service.

New service-measurement systems will help drive the achievement of the new service standards when implemented. Through conversation and consultation with the PRC, we have agreed in principle to the creation of a measurement system that joins independent, third-party measurement activities – essentially an expansion of today's independent External First-Class Measurement System – with robust internal measurements made possible through the implementation of the Intelligent Mail Barcode.

The new barcode will become mandatory in 2009 for mailers who take advantage of automation prices. Its use will allow us to combine a system that physically measures a limited, but statistically valid, sampling of our daily mailstream to one that passively measures an exponentially greater volume. For example, in December, with slightly more than 400 mailers participating, we collected more than one-billion Intelligent Mail Barcode scans. During the same period, our external, third-party system measured 250,000 pieces of mail.

The mail-flow data we collect will be the basis for a wide range of reports that customers can obtain and that can also serve as important diagnostic tools for the Postal Service. We believe this system represents the ideal synthesis of both systems – actual performance data measured in real-time as mail moves through our network, plus the validation offered by external sampling.

A second report by the Office of Inspector General, in November, addressed the adequacy and fairness of the Postal Service's process for the determination and appeal of Nonprofit rate mailings. The OIG's report found that "the assessments and appeals process was adequate and fair," and found no compelling reason for Congress to assign an outside body a role in the process. The OIG also determined that there was no need to establish a statute of limitations because of our existing 12-month time limit for revenue deficiency assessments. In the areas where it was recommended that we update and clarify our instructions, we agreed to do so.

The following month, the Postal Service's Board of Governors completed two workplace-diversity reports that were submitted to the President and to Congress. One addressed diversity within our management ranks and the other focused on purchasing contracts with minorities, women and small businesses.

The Board reported that although the total number of Postal Service employees has decreased since 2004, the representation of female and minority employees has increased steadily. Over the three-year period covered by the report, the percentage of Hispanic, Asian American Pacific Islander, Black, and White females in supervisory and managerial positions has increased.

The Board was also clear about its ongoing commitment to building strong relationships with small, minority-owned, and women-owned businesses. This commitment is reflected in the creation of a new *Supplier Diversity Corporate Plan – Fiscal Years 2007-2010*, which underlines the fact that supplier diversity is a proactive business process with the goal of providing suppliers with access to purchasing and business opportunities. The number and value of these contracts are tracked quarterly and annually, with sourcing and commodity strategies adjusted as necessary. In fiscal year 2007, the combined value of contracts with small businesses, minority-owned businesses, and women-owned businesses was $4.4 billion.

In recognition of our efforts to establish and maintain a strong, competitive supplier base that reflects the diversity of the supplier community, DiversityBusiness.com named the Postal Service as the Top Organization for Multicultural Business Opportunities and one of America's top diversity advocates.

Also in December, the Department of the Treasury submitted its recommendations to the Postal Regulatory Commission on the accounting practices and principles that will be used to separately account for our market-dominant and competitive products.

The Treasury's recommendations addressed our cost-attribution systems; the creation of a theoretical Postal Service competitive enterprise; the creation of a corresponding theoretical income statement using existing financial systems; attributable costs and cross-subsidization; the validation and adjustment of the costs of our universal service obligation; line-of-business costs and institutional costs; the use of a simplified approach for calculating federal income tax; and, sufficient independent review of supporting information.

Our review of the Treasury's recommendations indicates that they are consistent with our approaches to these issues. When completed and implemented, they will provide for a full and fair accounting for all costs and prevent any financial cross-subsidization of competitive products by market-dominant products.

At the same time, the Government Accountability Office issued an interim report to Congress on Postal Service and mailing industry mail-related recycling. The report found that the Postal Service, the mailing industry, and other stakeholders have undertaken numerous mail-related recycling programs, but could not quantify the extent to which these initiatives have been undertaken. The report lists several innovative stakeholder-identified opportunities to enhance recycling efforts but cautions that they must be considered within the context of mission compatibility, logistics, and cost. The GAO expects to issue a more comprehensive report in the spring.

In the meantime, the Postal Service will continue to plan, execute, and improve programs – internally and with industry partners – to minimize the impact of the mail and postal operations on every aspect of the environment. It is our goal to be a positive environmental influence in every community that the Postal Service calls home. Our investments in recycling, energy conservation, "green" vehicles, and "green" buildings continue to be recognized as innovative and effective. For the Postal Service, sustainability is more than just a concept – we are making it a way of life.

We submitted the initial version of our Annual Compliance Report to the Postal Regulatory Commission in late December. It includes data on product costing methodologies, service performance, and customer satisfaction. Because the Report covers fiscal year 2007, it is largely transitional in nature, as price setting during that period was governed by the provisions of the Postal Reorganization Act of 1970, not the Postal Act of 2006. Similarly, data contained in the report is primarily based on what has been filed in the past, in accordance with the requirements of the 1970 law.

As the Commission completes its rulemaking addressing the Annual Compliance Report, we make appropriate adjustments to its content and the sources of information that we will use. We anticipate filing our first official Annual Compliance Report this December.

Among the significant changes resulting from the new law is the requirement that the Postal Service comply with Securities and Exchange Commission rules that implement the financial internal controls under Section 404 of the Sarbanes-Oxley Act of 2002. We must also obtain an opinion regarding the effectiveness of Internal Controls over Financial Reporting from the Board of Governors' external audit firm. The Postal Service is the only federal agency with this obligation and we are on track to meet full compliance requirements by 2010.

To prepare for this, the Postal Service is following best practices and guidance published by the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC) We have established a top-down, risk-based approach to identifying, assessing, and reporting internal controls that can affect our financial reporting. We are also using the framework established by the Committee of Sponsoring Organizations, and which is approved by the SEC and PCAOB, to assess the key components of our internal controls.

In 2007, we achieved several key milestones in complying with the Sarbanes-Oxley requirements. We identified the systems and financial business processes that will fall within the scope of our efforts. We established an active SOX Steering Committee and Program Management Office. We targeted opportunities for business process improvements. And we are evaluating and assessing the key internal controls over financial reporting, allowing us to identify and resolve any discrepancies.

Earlier this month, we filed our first 10-Q Quarterly Financial Report with the Postal Regulatory Commission. Regular quarterly reports will follow, beginning in May. We will file our first 10-K Annual Financial Report in November.

Over the years, there has been considerable discussion about whether the Postal Service's status as a government organization provides us with an advantage – or a disadvantage – in the competitive marketplace. In an effort to provide a quantitative answer to this question, the new law directed the Federal Trade Commission to prepare a report regarding the federal and State laws that apply differently to the Postal Service than to the private companies that provide services similar to those in our competitive products category.

The FTC's study was far reaching and detailed, including input from the Postal Service, leading private-sector delivery companies, the Postal Regulatory Commission, Government Accountability Office, other government agencies, mailers, postal unions, and members of the public. In examining economic burdens compared to what it terms "implicit subsidies," the report concluded that the Postal Service is burdened with a unique "net competitive disadvantage versus private carriers." This is based on the costs of meeting our universal service obligation, as well as other laws and regulations that apply to the Postal Service but not to other carriers. The report estimates that these differences incur costs on the Postal Service that may exceed $550 million a year.

As I mentioned earlier, we will be implementing our first price changes using the new regulations on May 12. In the market-dominant product category, we have set prices carefully to satisfy the requirements of the law and to moderate the impact of the 2007 price changes for Standard Mail flats and Periodicals. Our proposed prices for these products, as filed with the former Postal Rate Commission in 2006, were in many cases less complex and below those recommended by the Commission in its decision of February 2007.

An important milestone established by the new law is the requirement that the Postal Regulatory Commission prepare a report on the Postal Service's Universal Service Obligation and the mail monopoly by the end of this year. These are important public policy questions that have been a rich source of study, conversation, and debate over the last several years.

The consequences of any proposals to modify our universal service obligation will be profound for every family and every business in every community throughout the nation. I believe the Commission's assignment – and the interests of the American people – can only be enhanced by its review and consideration of the existing body of work in these areas. On behalf of the Postal Service, we look forward to working with the Commission as it undertakes this important task.

Over the course of this year, the Postal Service will continue to break new ground as it implements innovative pricing structures for our competitive product category. They will reflect the flexible approaches now available through the new law and we expect to be announcing them soon. Our efforts are intended to make these products more attractive by providing shippers with incentives and other approaches that are common throughout the shipping industry, and that we have designed to support growth and profitability.

In many ways, the potential for growth remains largely within our control. It will be dependent on continued strong service, easy and convenient access, products that meet today's customer needs and anticipate those of tomorrow, the effective use of new pricing tools, and, of course, effective marketing and sales efforts – formal and informal – by every one of our employees in every part of our organization.

As we align our efforts with the regulations developed by the Postal Regulatory Commission, we need to continue to work with the Commission to ensure that the new regulations do not unnecessarily impede our ability to negotiate customized pricing and service arrangements with individual mailers – both in the market-dominant and competitive product categories. The intent of the new law was to remove the barriers that prevented the Postal Service from going to market quickly. But the prospect of an open-ended regulatory proceeding before any customized agreements could become effective can create uncertainty in the minds of our customers as to our ability to negotiate agreements that can, ultimately, be implemented.

An additional issue with this procedure is maintaining the confidentiality of the terms of a specific agreement – a common practice throughout today's business world. We are hopeful that we can continue to work with the Commission to resolve these issues in such a way as to fully capture the potential for creative and profitable customer arrangements embodied in the new postal law.

In pursuing growth, we also see tremendous opportunity in international products. We have improved our network, simplified product offerings, and made it easier for mailers to navigate complex customs and other processes that have served as impediments to expansion in the past. We appreciate the cooperation of our partners – other federal agencies, foreign postal administrations, the International Post Corporation, and the Universal Postal Union – in helping us to create an environment that supports the efforts of American businesses, large and small, to take advantage of international markets.

While we have benefited from changes in foreign exchange rates – a situation we cannot depend on in the long term – it is no surprise that good service sells. Our international mail volume has

grown by 18 percent over the last two years. We are working to position ourselves to continue strong growth in this product line.

Overall, the outlook for our international products is encouraging. Yet there are a number of situations that do cause us concern that we cannot resolve independently.

The first of these involves international air transportation. Today, the rates we pay air carriers for this service are governed by Department of Transportation regulations. Generally, we cannot negotiate rates based on market conditions, volumes, performance or other variables that are taken for granted in negotiating rates for the ground and air transportation of domestic mail.

Put in its simplest terms, a law that requires us to move toward even more businesslike management practices has placed us at odds with another law that, in this instance, prevents it. As we begin operations under a price cap that affects the lion's share of our business, we must find ways to reduce these and other costs.

We must also consider their effect on the customers who ultimately bear these costs. For example, the Department of Defense, one of the largest volume users of international air transportation for mail to APO and FPO addresses could have saved some $200 million over the last decade had we been able to negotiate with carriers. As we consider the needs of our national defense and the men and women of our armed forces – particularly during this time of conflict, it appears clear that this money could have been far better spent.

We have been discussing this issue with a number of air carriers and are hopeful that we can reach a consensus that supports the change to a negotiated rates solution. With such a system in place, the Postal Service could have benefited from approximately $500 million in cost avoidance over the last 10 years.

This limitation can only be removed through the efforts of Congress in introducing and enacting legislation that would permit negotiated rates for international air transportation.

A second issue of concern regarding international mail involves the entry of material generated by American businesses or government agencies directly into the mailstreams of foreign postal administrations. For example, an American business may prepare a mailing for customers or potential customers with addresses in Mexico. The originator would bypass the United States Postal Service and work through a third party to pay Mexican postage and deposit the mail through Mexico's Post Office.

The third parties can be other foreign posts, such as Germany's Deutsche Post, or private businesses that maintain a presence in Mexico or other nations for this purpose. When the third party is another postal administration, this type of office is known as an Extraterritorial Office of Exchange (ETOE). This is a legitimate practice and one sanctioned by the Universal Postal Union.

Unfortunately, our experience has shown that the activities of some foreign posts and consolidators can result – inadvertently or otherwise – in lost revenue and increased costs for the United States Postal Service.

This often occurs when material entered through foreign posts is returned to its American originator through our mail system because it is undeliverable as addressed. However, because it did not originate as United States mail with United States postage, we incur added costs for its return. The actual mailer, the foreign-based ETOE or consolidator, should be the recipient of the returned mail and responsible for its costs.

But in many instances, the return address on the mailpiece identifies only the originator of the mail in the United States, not the actual sender, incorrectly leading to the assumption that the item began its journey as U.S. Mail.

In other cases, the ETOE or consolidator improperly uses Universal Postal Union forms and coding to suggest that the material was mailed through the United States Postal Service. We have also found that some may use our mail containers when presenting this material to a foreign postal administration, again suggesting that the material was mailed in the United States.

Payment for the reciprocal exchange of mail between nations is governed by a system of international tariffs known as "terminal dues." When material is misidentified as United States Mail, it can skew the actual mail volumes involved, reducing payments due to us or increasing our payments to other posts.

A third situation occurs when an ETOE or consolidator deliberately misdirects its products to the wrong country. For example if an entity operating in the United States does not have a shipment of sufficient weight to a destination country, it may deliberately ship its material to a country to another nation for which the weight threshold is satisfied. If that occurs, the receiving country may forward the shipment to the actual destination country at the expense of the United States Postal Service.

Perhaps a more serious consideration is the fact that United States screening and safety standards, designed to enhance homeland security, may not be employed by ETOEs or consolidators. This means that material improperly reentering the United States as mail has not been subject the same rigorous scrutiny as international mailings actually initiated through the United States Postal Service.

We are working to address our concerns through other posts and the Universal Postal Union. These efforts can be enhanced through increased awareness among federal agencies that utilize third-party international mailings as well as the creation and application of stronger standards for operators who maintain a presence in the United States. Your understanding and support of our efforts can be of tremendous assistance and avoid unnecessary costs for American mail users.

Before I close, I want to acknowledge the work of Comptroller General David Walker over the last decade as the Postal Service intensified its efforts to become more effective and more efficient than ever. Mr. Walker understood that the ultimate transformation of the Postal Service was not simply an organizational issue; it was a critical public policy issue. He understood the need for new legislation that would provide the Postal Service with the flexibility necessary for success in a radically changed and dynamic business environment. I offer Mr. Walker my best wishes as he moves on to a challenging new phase of his career.

We are entering a period of profound change. Through the new postal law you have provided us with a new ability to navigate that change. As we begin this journey, I am grateful for your continuing support of a sound and financially independent Postal Service.

I would be pleased to answer any questions you may have.

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Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Potter. We will proceed to Mr. Bilbray.

STATEMENT OF JAMES H. BILBRAY

Mr. BILBRAY. Thank you, Mr. Chairman. Please don't confuse me with my crazy cousin Brian, too. He went bad somewhere along the line and became a Republican.

Anyway, Chairman Davis, Ranking Member Marchant, not here, but members of the committee, thank you for inviting me here today. This is my first opportunity to testify before you as member of the Board. I have only been on—this is the beginning of my second year.

I want you to know that I am honored and pleased that my fellow Governors have asked me to represent the Board today, and I take this responsibility very seriously. I am fortunate to serve on a strong board with committed members who have a wide range of experience in business and public service. I am fortunate that we have an excellent leadership team.

The record speaks for itself, postal employees are providing record levels of service to the American public. Our employees and leadership team have risen to the occasion during particularly a challenging time. As we know, mail volumes have gone down and fluctuated, consumer habits and pricing is changing, and weather conditions have plagued much of the country, affecting mail service. Each of our labor contracts had to be renegotiated and worked on successfully.

Against this backdrop the most significant change in our 35-year plus history is the passage of the Postal Accountability and Enhancement Act of 2006.

Last year the Postal Service, the Postal Regulatory Commission, and a myriad of other stakeholders and mailers immediately went to work to implement the new laws provisions. Under the guidance of PRC Chairman Dan Blair and Postmaster General Jack Potter, we have tackled these challenges aggressively. As a result, and in some cases ahead of schedule, timetables in the law have been met.

Today some 14 months later we can collectively be proud of our progress. We are pleased to report to Congress to date we have detected no need for changes in the new law. And so far parties have the tools necessary to implement the law as Congress intended.

I would like to recognize the PRC for its hard work in enabling this to happen. The Postal Act in 2006 changed 35 years of history by creating a new pricing model. The Governors had an option to file one last rate case under the regulations used since 1971. However, under Dan Blair's leadership, the PRC accelerated the finalizing of their pricing rules which allowed the Governors to choose to move forward under the new pricing rules. This was an important vote of confidence in the new system.

Across the spectrum the Postal Service is working to deliver for the future. We are engaged in a broad effort to implement the wide range of requirements in the new law and have spent much of the first year meeting with the PRC, our Federal agency unions and mailers.

Congress requested two updates from the Board on different aspects of diversity within the postal system. The first dealt with the

extent that women and minorities are represented in supervisory and management positions. The second centered upon the number and value of contracts and some contracts the Postal Service has with women, minorities and small businesses.

The Postal Service remains one of the leading employers of women and minorities. Representation of both groups has continued to increase. Consider that last year minorities represented 38 percent of the work force in the USPS. The Board is equally proud of the Postal Service's commitment to building strong relationships with small minority owned and women owned businesses.

The Board recognizes the Postal Service work is never done in this area. We are a dynamic, changing society with changing demographics. The Postal Service is competing with both Federal agencies and private workplaces for the best and brightest talent. But we have strategies in place to counter this. We have formed a talent and acquisition group, and they are recruiting on our college campuses and military bases.

Last year the Postal Service issued a new supplier diversity corporate plan. The plan focused on continuous improvement of our business relationships with small minority-owned and women-owned businesses. We remain committed to a competitive supplier base. The Post office mission to provide universal service was reaffirmed by the new postal law. Our mission is still to provide every American with real world access and affordable, dependable mail service, even though we have nearly 2 million new addresses per year.

To help support the universal service, the Postal Act allowed greater price flexibility for shipping services. We recognize the significant challenges posed by some of the fiercest competitive global companies in the realm. We are forging ahead to provide options to the American public. The Postal Service has set up a new express mail division and ground package unit to focus efforts on this market.

As Governors set the strategic direction of the Postal Service, we are continuing to seek improvement and providing value to the American public, organizing, communicating that 685,000 employees in a new way of thinking. A new way of doing business is no small task. Congress understood the challenges brought about by the changes in the marketplace and technology and now Postal Service employees are delivering.

Much of the new law's first year was devoted to setting up our future systems and processes. We have begun the next phase, implementation. Much more critical deadlines are fast upon us for this year, but 2007 and 2008 thus far have been good, productive years. We have learned much, forged new partnerships, and had interesting debates and discussions.

On behalf of the Board, I would again like to thank you and acknowledge Postmaster General Potter and PRC Chairman Dan Blair and our stakeholders who have worked tirelessly to ensure the groundwork was laid to position the Postal Service well into the years to come. Thank you, Mr. Chairman and members of the committee and Mr. Waxman.

[The prepared statement of Mr. Bilbray follows:]

BOARD OF GOVERNORS
UNITED STATES
POSTAL SERVICE

STATEMENT OF
JAMES H. BILBRAY

BOARD OF GOVERNORS
U.S. POSTAL SERVICE
BEFORE THE
SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE
AND THE DISTRICT OF COLUMBIA
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 28, 2008

Chairman Davis, Ranking Member Marchant, and Members of the Subcommittee: Thank you for inviting me today. This is my first opportunity to testify before you as a member of the Postal Service Board of Governors. I want you to know that I am honored and pleased that my fellow Governors have asked me to represent the Board here today and that I take this responsibility very seriously.

I am fortunate to serve on a strong board with committed members who have a wide range of experience in business and public service. I am also fortunate that we have the leadership skills of Postmaster General Jack Potter and his dedicated team. The record speaks for itself: postal employees are providing record levels of service to the American public.

Our employees and leadership team have risen to the occasion during a particularly challenging time as mail volumes have fluctuated due to changes in the economy, consumer habits, and pricing changes, while severe weather plagued much of the country, and each of our four labor contracts had to be renegotiated.

Against this backdrop, the most significant change in our 35-year-plus history occurred – the implementation of *the Postal Accountability and Enhancement Act of 2006.* Last year, the Postal Service, the Postal Regulatory Commission (PRC) and a myriad of other stakeholders and mailers immediately went to work to implement the new law's provisions. Under the guidance of PRC Chairman Dan Blair and Postmaster General Jack Potter, we tackled this challenge aggressively and as a result have met, and in some cases, exceeded the timetables set in the new law's provisions.

Today, some 14 months later, we collectively can be proud of our progress. We are pleased to report to Congress that to date we have detected no need for changes in the new law and that so far parties have the tools necessary to implement the law as Congress intended.

The process has been new and challenging. However, due to the cooperation and collaboration between all stakeholders, we have established a sound framework to move forward.

I would like to recognize the PRC for its hard work in enabling this to happen. For more than 35 years, the world's largest and most complex postal service operated under one set of rules. The Postal Act of 2006 changed all of that by creating a different pricing model. As you all know, the Governors had the option to file one final rate case under the regulations used since 1971. However, under Dan Blair's leadership, the PRC accelerated finalizing their pricing rules, which allowed the Governors to have the option to move forward under new pricing rules. At our November 2007 meeting, the Governors determined that the right thing to do was to get on with

the future. So, we voted to proceed with the new pricing regulations contained in the *Postal Accountability and Enhancement Act*. That was an important vote of confidence in the new system.

This exemplifies the dedication and teamwork that has been built around ensuring the new law's success. And it is just one of many incidences of the kind of collaboration taking place. Across the spectrum, USPS is working to deliver the future as envisioned by the new law. We are engaged in a broad effort to implement the wide-ranging requirements of the new law, and have spent much of the first year meeting with the PRC, our fellow federal agencies, unions, mailers and other stakeholders.

Another effort involving collaboration with many parties has been the establishment of modern service standards. New standards have been identified for mailing services and submitted to the PRC for review, and work has begun on defining the corresponding performance measurement systems. Again, nothing could be more critical to the Postal Service since the heart and soul of the agency is its commitment to service and its ability to deliver record service.

I'm proud of the record service that the Postal Service has provided over the past several years. And I'd like to think that the Board has played a vigorous role in helping management make a commitment to record service during these most challenging economic times. It's a phenomenal story and one in which the Board played a significant role because of its commitment to funding modern technology while retaining the power of postal employees.

The Board has been very involved in the implementation of Sarbanes-Oxley, with which the Postal Service is mandated to comply in the new law by 2010. There is no roadmap for government agencies in meeting SOX principles – we are the first to go through this process. But we are confident in our ability to deliver a robust compliance on time, if not ahead of schedule.

The Board's audit and finance subcommittee has taken its oversight responsibilities seriously, consulting with experts to revise our processes and requirements.

In addition, the Postal Service identified a Financial Control Group—an entire division within finance to establish the parameters of this vast mandate touching hundreds of accounting and reporting systems within the agency. The team has identified the scope of their work and is now finalizing their communications and training plans.

Congress requested two updates from the Board on different aspects of diversity within the Postal Service. The first dealt with the extent that women and minorities are represented in supervisory and management positions; the second centered upon the number and value of contracts and subcontracts the Postal Service has with women, minorities and small businesses.

The Postal Service remains one of the leading employers for women and minorities. Representation in both groups has continued to increase. Consider that last year, minorities represented more than 38 percent of the workforce. In supervisory and managerial positions, the numbers of Hispanic, Asian American Pacific Islander, white and Black females has increased. The number of Black males in supervisory and managerial positions has decreased slightly, but this is directly attributed to the high number of retirements of Black males during the past three years.

The Board is equally proud of the Postal Service's commitment to building strong relationships with small, minority-owned and women-owned businesses.

The Board recognizes that the Postal Service's work is never done in this area. We are a dynamic changing society with changing demographics. There are 100,000 fewer postal employees today than a few short years ago. The Postal Service is competing with both federal agencies and private workplaces for the best and brightest talent. There are limitations to the incentives that we can offer and sometimes bright young prospects might have an antiquated view of the Postal Service. But we have strategies in place to counter this. We have formed a

new Talent and Acquisition group and they are out recruiting on college campuses, and at military bases. Our recruiters have personal relationships with groups all over the country, such as Blacks in Government and the National Hispana Leadership Institute, as they work hard in attracting prospective employees.

Last year, the Postal Service issued a new Supplier Diversity Corporate Plan. The plan focuses on continuous improvement in our business relationships with small, minority-owned and women-owned businesses. We remain committed to a competitive supplier base.

It is only through utilizing a diversity of thought, experience and background that the Postal Service will be able to excel in the coming years. It is our fundamental position that diversity of employees is not only an excellent policy, but that it is also an excellent business practice.

Despite all of these changes, our basic values have remained the same. The Postal Service's mission to provide universal service was reaffirmed by the *Postal Accountability and Enhancement Act*. Our mission is to still provide every American in every community with universal access to affordable, dependable mail service.

To help support that universal service, the Postal Act allowed greater pricing flexibility for shipping service. We recognize the significant challenges posed by some of the most fiercely competitive global companies in this realm but we are forging ahead to provide options to the American public. The Postal Service has set up new Express Mail and ground package divisions to focus efforts on this segment of the market.

The Board recently approved two new exciting products. The new Priority Mail Flat Rate box enables customers to ship 50 percent more than with the current box, which by the way I'm pleased to say will be offered at a discount to overseas military addresses. And in January, the Governors also approved new Sunday and holiday premium prices for Express Mail, which go into effect next month. These two actions represent some of the first initiatives we have taken under the pricing flexibility given to the Postal Service under the new law.

As the Governors set the strategic direction of the Postal Service, we seek continual improvement in providing value to the American public. Meanwhile, the challenge for postal management is to focus on fundamentals—What do we need to do to ensure high levels of consistent service to the American public? What does the USPS have to do to ensure revenue growth? And, finally, are we delivering the kinds of products that the marketplace wants and needs? The leadership team has done a commendable job in adjusting internal systems to meet newly defined standards, and the Postmaster General's discipline, drive and direction has delivered results. Organizing and communicating to 685,000 employees a new way of thinking, a new way of doing business is no small task. Congress inherently understood the challenges brought about by changes in the marketplace and technology, and now postal employees are delivering.

In closing, much of the new law's first year was devoted to setting up future systems and processes. We have begun the next phase—implementation. Many more critical deadlines are fast upon us for this year. But 2007 and 2008 thus far have been good, productive years. We have learned much, forged new partnerships, and had interesting debates and discussions. On behalf of the Board, I'd like to once again thank and acknowledge Postmaster General Jack Potter, PRC Chairman Dan Blair and all of our stakeholders who have worked tirelessly to ensure that the groundwork has been laid to position the Postal Service well for the years to come.

Thank you, Mr. Chairman and Members of the Subcommittee. I would be happy to answer any questions that you might have.

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Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Bilbray. And Mr. Blair, with your indulgence we are going to alter the procedure just a bit. Chairman Waxman is under tremendous time constraint, but has questions that he would like to ask, and I would like to yield to him for the questions and then we'll return it our normal procedure.

Mr. BILBRAY. I love that title, Chairman Waxman.

Mr. WAXMAN. Thank you very much.

Thank you very much. And than you very much, Mr. Chairman, for letting me ask my questions, and forgive me for interrupting the testimony of the panel.

We had some hearings in our committee about charities that are supposedly helping the veterans and these groups raise money to assist U.S. military personnel and veterans, but a number of these veteran groups spend far more on executive salaries and fundraising than they do on delivering goods and services to the veterans. For example, we had testimony from one of the fathers of a veteran who was wounded in the Iraq war, and he was struggling. The father ended up giving up his job just to try to take care of the followup medical services for his son. And when he heard about these so-called veterans charities that raise money and pocket most of it and used a little bit for the helping of the veterans, he said, my son as well as the other thousand of injured soldiers from this war or any other war are not commodities. I don't think it is right that you can use these soldiers as commodities to raise funds and then turn around and give a small percentage of that to what you're saying you are going to do with the contributions.

Since that hearing, my staff has been talking to charity experts and regulators to understand how these groups can get away with this sort of thing. We had heard that one important factor is the lack of disclosure and awareness by donors about how charities are spending their money.

There is man by the name of Roger Chapin. He is the head of Help Hospitalized Veterans and Coalition to Salute America's Heroes, two of the veterans charities that appear to be abusing their nonprofit status. His testimony at our hearing was quite revealing. He said, if we disclose, which I'm more than happy to do, we'll all be out of business and the charities will be out of business and nobody would donate and it would all dry up. This is his words to justify the very small amount of money that actually got to the veterans. And he, by the way, was making a very nice income on all of this.

The disclosure is one of the problems, but another appears to be an exception to the cooperative mail rule. Under this rule, which Mr. Potter instituted in 2003, for-profit fundraisers are able to use the nonprofit mailing rate so long as they share a small part of the proceeds with a nonprofit organization. My concern is that this rule allows unscrupulous fundraisers to negotiate contracts that enrich the for-profit companies and take away funds from the intended beneficiaries.

Mr. Potter, we've been talking to the National Association of State Charity Officials and other charity experts, and they are telling us that this cooperative mail rule is being abused. They describe situations where the for-profit direct mailers keep both 80

percent of the proceeds and the list of donors. They told us that these arrangements are abusive because the nonprofit gets so little of the money and yet at the same time becomes dependent on the mailer because of the mailer's control of the donor list.

I have two questions for you, Mr. Potter, are you concerned about the abuse that appears to be occurring? And two, what steps are you going to take to address these issues?

Mr. POTTER. Thank you, Mr. Chairman. Yes, I am concerned about the abuses. When we instituted that rule in 2003, the motivation was to try and help charities because there were many charities who did not have the funds to put up for the mailing campaigns that they had. And so it was a matter of having others take risk, and that was the motivation, was to help. Obviously it has backfired in some cases, so we are exploring and we have been monitoring the hearings that you've had.

Mr. WAXMAN. Good.

Mr. POTTER. We are very concerned about some of the abuses that you through your hearings have identified and we are exploring ways of changing that rule such that we can make the American public more aware of, you know, the actual—through our regulations, through the actual charity, the actual amount of funds that ends up in those who they were intended for. And we're continuing to try to figure out how to do that. At the same time——

Mr. WAXMAN. I want to address the same question to Mr. Blair because he is the head of the Postal Regulatory Commission. In the 2006 legislation I insisted on a provision that gave the PRC the authority to examine the abuses of the nonprofit rate, make recommendations to the Postal Service, and act on its own initiative if the Postal Service didn't respond.

We want the Postal Service to thrive. We know they are facing difficult challenges, but it is not acceptable for the Postal Service to encourage these deceptive mailings simply because they may generate more volume for the Postal Service. And this is a problem that I think ought to be addressed.

I'd like to ask you the same two questions. Are you concerned about the abuse that appears to be occurring? And what steps would you be willing to take to address these issues?

Mr. BLAIR. I appreciate you, Mr. Chairman.

I appreciate you raising this with us. This is an issue at first impression with us. I'm not aware of the former rate commission or the regulator at this point undertaking these types of investigations. We'd like to certainly learn more about this. You reference a section in the new law. That's something that we certainly would look at and we'll be happy to work with you.

On first impression I look at this and I see this as the Inspector General's primary role as well. We work quite closely with the IG's office at the Postal Service. While we look at the data and we look at the rates, any revenue protection and law enforcement seem to be their primary purview, but we're happy to work with you and your staff to see what we can do in this regard.

Mr. WAXMAN. I thank you very much. I think it is an important issue. I want to bring it to both of your attentions, and perhaps the IG ought be involved as well, but I would like you to review it because I think it is being abused.

Thank you for your courtesy, Mr. Chairman, I appreciate it. I regret that I have to leave to go to California, not that I regret going to California, it is always a wonderful place to go, but I have to leave. Thank you very much.

Mr. DAVIS OF ILLINOIS. If it was anyplace else we wouldn't—thank you very much, Mr. Chairman, and thank you, Mr. Blair. And we can now proceed to your opening statement.

Mr. BLAIR. You saved the best for last, right, Mr. Chairman?

Mr. DAVIS OF ILLINOIS. That's right.

STATEMENT OF DAN G. BLAIR

Mr. BLAIR. Mr. Waxman, Mr. Davis, thank you. I appreciate this opportunity to present you with an update of the activities of the Postal Regulatory Commission. I am pleased to be here with Postmaster General Potter and Governor Bilbray, and I appreciate their kind words about the Commission as well. My written testimony gives a complete agenda of our activities, but I am pleased to summarize my statement.

It has been a very busy year for us at the Commission. Standing up the regulatory framework 8 months ahead of schedule, consulting with the Postal Service on the development of modern service standards, completing one last final rate case under the old regulatory regime tops the list of those activities. It was a fulfilling year, but we can't rest on our accomplishments since the upcoming year presents equal, if not greater challenges.

Our agenda includes further consultation on service standard goals and performance measurement systems. I want to compliment the Postmaster General and his team at the USPS, headed up by Deputy PMG Pat Donahue, for their work with us on the development of the service standards and our continuing consultation.

The PRC's efforts in this area added value, and I'm pleased that many of our suggestions over the past few months were incorporated in the final performance standards. Our monthly meetings have proved to be a good conduit for consultations and communication into other issues which rise from time to time. This open and ongoing dialog helps make our system work better, and I look forward to continuing this practice.

Currently we are undertaking two new Postal Accountability Enhancement Act reviews. First, we are reviewing the data provided by the Postal Service as part of its annual compliance report, annual review in the rate adjustment filing under the new regulatory framework submitted by the Postal Service on February 11th. With the experience gained in the review of the first annual data submission by the Service we will shortly propose rules to tighten the process. The review of the first annual report has identified areas for data collection, special studies and cost models can be updated.

We are also beginning work on the universal service obligation study which was mandated by the PAEA. We plan to seek the views from the Postal Service, other Federal agencies, the postal community and general public on their expectations of universal postal service.

Given the scope of this study, we are supporting our commission of work through a competitively awarded contract with George

Mason University School of Public Policy. Your first witness today, Professor Wolak, will be among those providing assistance to the Commission as part of GMU's work for us.

We expect to engage in broad public outreach as well as conduct several field hearings to gauge the mailing public's needs and perceptions in this area. We plan a very comprehensive and well-documented report.

As I mentioned in my statement, we believe our congressionally mandated report will have the benefit of the findings and recommendations of a separate report being prepared by the Postal Service through the National Academy of Science. I want to thank Postmaster General Potter for his assistance in this effort.

To conclude, Mr. Chairman, those are several of our front burner issues. An additional priority is to see the successful nomination of the new commissioner to fill our one vacant seat. I am pleased to report that yesterday President Bush nominated Nancy Langley to fill that seat. Many of you may know Nancy from her longtime work for Senator Akaka on the Homeland Security and Governmental Affairs Committee. She's currently the Commission's Director of Public Affairs and Government Relations. I'm sure you will join my fellow commissioners and me in wishing her a speedy confirmation.

My written testament goes into further detail. I am pleased to answer any of your questions.

[The prepared statement of Mr. Blair follows:]

Testimony of

The Honorable Dan G. Blair, Chairman

On Behalf of the

Postal Regulatory Commission

Before the

U.S. House of Representatives

Committee on Oversight

And Government Reform

Subcommittee on Federal Workforce,

Postal Service, and the District of Columbia

February 28, 2008

Thank you Chairman Davis, Ranking Member Marchant, and members of the Subcommittee. I appreciate this opportunity to review with you the activities of the Postal Regulatory Commission since the enactment of the Postal Accountability and Enhancement Act (PAEA) on December 20, 2006.

It has been an exciting and challenging fourteen months as the Commission transitioned into its role as the strengthened regulator from the former rate maker. Just a year ago, on February 26, 2007, we issued our recommended decision on the last omnibus rate case to be considered under the old Postal Reorganization Act of 1970. Less than a month later, at a joint Commission-Postal Service forum on the PAEA, I asked the attendees if they would like to see new ratemaking systems in place before the June 2008 statutory deadline. Fueled by an enthusiastic response favoring regulations "sooner, rather than later," the Commission beat the deadline by eight months. Our hard work set the stage for the first rate increase under the PAEA and resulted in the Postal Service foregoing one final rate case under the old law.

Completing the ratemaking regulations ahead of schedule is just one of the many tasks we undertook last year. In addition to establishing a new ratemaking process, the Act requires the Postal Service – in consultation with the Commission – to develop modern service standards for all market dominant products by the end of 2007. To guarantee public participation in the process, we solicited written comments from mailers and consumers and held three field hearings outside of Washington, DC, where witnesses shared their expectations for service standards and ratemaking regulations. We are now in the second phase of our consultation – establishing goals for performance measures and network reorganization which is due to Congress in June.

To further our commitment to a primary cornerstone of the new law – accountability and transparency – we reorganized the Commission. A comprehensive management review aided in the identification of key strategic goals, which allowed us to align our goals and office functions with the Commission's multiple mandates of the PAEA. We also began a complete redesign of our agency's website to ensure greater public accessibility and ease of use that will be completed this spring. A complementary activity is the upgrading of our Information Technology systems. We also appointed an Inspector General, as required by the law, who has provided the first semi-annual report to Congress.

In addition, the PAEA directs a new funding process for the Commission. Prior to enactment of the new law, the Commission submitted its annual funding requests directly to the Governors of the Postal Service, which in turn, directed the Postal Service to fund the Commission's budget from the Postal Service Fund. The Act sought to ensure the Commission's independence through the appropriations process by having Congress instruct the Postal Service to fund the Commission's budget from the Fund. I wish to thank the Chairman for his support of the Commission's appropriations submission for Fiscal Year 2009.

I am extremely proud of our accomplishments last year. However, the Commission will be even busier this year. As you know, the Postal Service filed rate increases for market dominant products with us on February 11, 2008. This filing puts into motion the regulations we finalized last October. Interested parties have until March 3, 2008, to submit comments to the Commission regarding the rate increases that will become effective on May 12, 2008. Once the public comment period ends, the Commission will have 14 days to review the comments, decide if the rate changes meet the requirements of the PAEA, with particular focus on satisfying the CPI based cap, and issue an order. Although the PAEA ensures a minimum of 45 days advance notice, the Postal Service is providing 90 days notice.

At the same time that the Commission is reviewing the first market dominant rate increase, we are also completing our first Annual Compliance Report. Work is underway to analyze the Postal Service's costs, revenues, and service data from fiscal year 2007. We have held two technical conferences regarding changes proposed by the Postal Service for Periodicals cost models, and we have asked for public comments on all aspects of the Service's Compliance Report filed with us at the end of 2007. This annual review, required by the PAEA, is due by March 27, 2008. Successfully managing these two responsibilities simultaneously, and within a compressed timeframe, demonstrates the Commission's ability to balance its resources and staff effectively. I would like to note that this year's compliance analysis will report on rate increases under the old cost-of-service system, which did not separate postal products. Future reports will analyze data for the two categories of mail established by the PAEA – market dominant and competitive products.

It is our obligation to develop, with input from the Postal Service and the mailing community, rules to ensure that the Postal Service provides sufficient reliable data to enable the Commission to prepare accurate and informative reports and studies as required by the PAEA. Good data is the foundation that supports meaningful transparency and allows for careful and conscientious analysis, and reports that provide real accountability.

We are engaging in other critical activities related to PAEA mandates, including the development of accounting principles and methods to calculate the "assumed" Federal income tax on competitive products. Our final rules will be issued no later than December 20, 2008, and will have the benefit of recommendations made to the Commission by the Department of Treasury at the end of 2007, in addition to public comments, which are being solicited now.

I wish to note that applying an assumed Federal income tax on competitive products is a unique requirement of the PAEA. Approximately 10 percent of the Postal Service's revenues are generated by products, such as Priority Mail and Express Mail, which are offered in competition with private firms. By law, the Postal Service must compute an approximation of the Federal income tax it would pay on its competitive products to ensure fair competition with the private sector. We will have final rules by the end of 2008.

We are currently working on our report to Congress on the universal postal service (USO) and the postal monopoly, due by December 20, 2008. Commission staff, assisted by a contractor, will review the history of the postal monopoly, including the Mail Box rule, universal service in the United States and other countries, and the varied needs of individuals and businesses. To ensure active public participation, we plan to hold field hearings early this summer as well as solicit public comments. We are also asking the Postal Service, which is conducting its own review of the USO, to provide the Commission with the benefit of its recommendations and observations prior to releasing our final report to Congress. Further, we look forward to consulting with the Service, as required by the PAEA.

Another activity of interest to Members of the Subcommittee is the initiation of discussions with the Postal Service on a joint Commission-Postal Service review of Periodicals costs required by the PAEA. Although the Act did not specify a completion date for this report to the President and the Congress, we believe that comments made during the October 30, 2007 hearing before the Subcommittee justify the undertaking of the review now.

Mr. Chairman, I have laid out how the Commission moved quickly over the past 14 months to meet its responsibilities under the new law. We have shaped the new postal regulatory environment, and we are meeting our newly mandated responsibilities well. As part of this new environment, we are mindful that the Commission's strengthened regulatory authority includes our ability to issue subpoenas, order remedial actions, and levy fines in instances of noncompliance with applicable postal laws. We are formulating a new formal complaint system to strengthen the Commission's existing process to ensure even greater transparency and accountability. Work has begun on drafting new regulations, and we are instituting a system to process and track informal consumer concerns. Because so many consumer inquiries to the Commission are outside of our scope of responsibilities and relate to postal delivery service issues and operational matters, our Office of Public Affairs and Government Relations works closely with the Postal Service's Office of Consumer Advocate to ensure more timely and responsive actions.

I would like to address one final issue before I conclude my written remarks. I wish to discuss the future of agreements between the Postal Service and individual mailers, commonly referred to as Negotiated Service Agreements (NSAs). Up until very recently, the Postal Service operated as a tariff industry – offering products on the same terms to all its customers. However, in 2002, the Postal Service began negotiating contracts with specific mailers.

The PAEA codifies the use of the NSAs as one of the factors of the Act, and contemplates an expedited review process that we interpreted through our ratemaking regulations. The law is very specific, and our regulations directly reference section 3622(c)(10), among other provisions, as the basis for the Commission's review of NSAs. This section requires that market dominant NSAs must either improve the net financial

position of the Postal Service or enhance the performance of operational functions. In addition, NSAs may not harm others in the marketplace and must be available to similarly situated mailers. Competitive product NSAs must cover attributable costs.

I wish to assure the Subcommittee that we will review NSA filings from the Postal Service in this light. Moreover, reviewing the data behind these filings will be a critical component of the Commission's Annual Compliance Report to Congress. I understand many stakeholders may have questions about the Commission's review of NSAs under the new rules and the guidelines and criteria the Postal Service uses in evaluating a potential agreement. To address these questions, the Commission looks forward to working with the Postal Service in an effort to explore ways of resolving stakeholder questions and issues on how to best utilize NSAs.

In closing, I wish to thank the Subcommittee Members for their continued support of the Commission and our activities. I also wish to thank the Members for their work in bringing about postal reform. Moving from the lengthy, highly litigious rate cases in favor of annual rate increases capped at the CPI allows businesses to foresee their mailing costs. The predictability of rate increases and the transparency of the data behind cost adjustments will bring more value to the mail.

Thank you, and I will be more than happy to answer any questions the Subcommittee may have.

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Blair. I want to thank all three of our witnesses for your indulgence and for being here with us this afternoon.

Mr. Potter, let me discuss, can you give us a status report on the financial reports in the second quarter to date and indicate whether or not the economic downturn that we've heard so much about has continued to affect postal revenues.

Mr. POTTER. Mr. Chairman, as I said in my opening statement, our revenues after the first quarter went down some $525 million. After the first 2 months of the second quarter they are down another 400 million. So the economy continues to hurt the Postal Service's revenues.

Mr. DAVIS OF ILLINOIS. Also, last year the Postal Service issued a request of information related to outsourcing the mail processing activities conducted in its bulk mail centers. Could you tell us the status of this proposal and whether or not it involves outsourcing a core postal function?

Mr. POTTER. We received that—got the information through that request for information. We've analyzed that information, we've shared it with our unions, we are working with the American Postal Worker Union and the Mail Handler Union. We intend to go out with a request for proposal. Again we are doing it in consultation with them, very close consultation with them. That's where we are at right now.

Mr. DAVIS OF ILLINOIS. I also know that the Postal Service, and we were pleased to see the Postal Service and the National Association of Letter Carriers reached some agreement and the agreement ended up being a 6-month moratorium, only in the efforts to contract out the delivery of city or suburban routes. The moratorium ends next month. What do we see happening at this point?

Mr. POTTER. Well, part of that agreement was we would enter into a period of dialog with the NALC. We got off to a slow start. It has become productive and we have extended that moratorium through the end of July.

Mr. DAVIS OF ILLINOIS. And so there will be continuous discussions I would——

Mr. POTTER. We are doing it because the discussions have been productive. As I said, we got off to a late start so we didn't want to curtail them, and we're hoping that we're able to work that issue through and reach an amicable agreement on it.

Mr. DAVIS OF ILLINOIS. Let me be just a little bit self-serving. You did mention in your testimony record service performances for first class mail. What has been the experience in the Chicago area?

Mr. POTTER. Mr. Chairman, as you know all too well, we had service problems in Chicago for the last couple of years. I'm very proud of all the folks in Chicago who have really stepped up their efforts to improve service. We have seen a great improvement in overall service in the city of Chicago. It is through the efforts, as I said, everyone who works there. They've worked hard to improve the quality of addresses that we have in Chicago in our address data base. We have upgraded all of our machines. We are in the process of upgrading our facilities, and we've realigned our staffing. And so I think you can count on the fact that service will continue to get better there.

Mr. DAVIS OF ILLINOIS. Would the activities that took place be perceived perhaps as a model or an approach that might be used in other areas that might be experiencing and are having the same problems?

Mr. POTTER. I think the approach is one that could be replicated in other places where similar problems hopefully don't exist today, but if they were to happen we could replicate that effort in Chicago in other locations.

Mr. DAVIS OF ILLINOIS. Thank you very much.

Mr. Bilbray, let me ask you, has the Board of Governors' role changed in your perception since the postal reform law was enacted?

Mr. BILBRAY. Mr. Chairman, it has in the sense that again I was only a member of the Board for a short period before the change took place. But in talking to other members that were there before and also the few months that I was there before, our load has really increased. I think it is because we have the Sarbanes-Oxley provisions going forward. The Audit Committee is meeting all the time. I mean they meet, where they used to meet maybe 3 or 4 hours about every fourth week. When they do meet 2 or 3 days it's—we're on the phone constantly, not only with the meetings that we personally come to, but telephonic meetings. Virtually everything that is done is with the goal of transparency. I know we have—they don't have to call us on levels that are spending below certain amounts. The fact is it seems like with the cost of everything going up and even the cost of construction, I mean we've had to pull back on construction, because construction costs are shooting out of sight and our bids are coming in at 25, 30 percent higher than we estimated. So the board is really active.

When I was asked to serve by Senator Reid on this board and went through the process, nobody told me that it would be a full-time position but a part-time position. But it virtually is. I spend 2 to 3 hours a day going through documents sent to me from the Postmaster General and his office. It is quite a job and just remember something I would like to point out, the $300 we get paid per meeting was set in 1970. Hint, hint.

Mr. DAVIS OF ILLINOIS. Maybe Senator Reid just didn't want you to get too comfortable.

Mr. BILBRAY. I can tell that.

Mr. DAVIS OF ILLINOIS. In your testimony you also put emphasis on the role of minorities and women, especially as it relates to small business and small business development and activity. The Board was required under the Postal Accountability and Enhancement Act to conduct a study on the representation of women and minority members in supervisory and management positions. Would you reemphasize for us the findings to date of that study?

Mr. BILBRAY. Mr. Chairman, the findings are out, the recommendations are not. And what I was told by staff before I came here is that they were finalizing that and that would be made available to the committee and to yourself as soon as we—but we have increased, they say, the numbers—we're not—in fact I asked for it. I said can you give me the total percent, just like they did with 38 percent of our postal employees are minorities or women. I asked for the number, the total number, and they said it is not

broken down that way, it is broken down into a percent here, a percent there, something here. And I said, well, that's not satisfactory. So they said they would get that information for me as soon as possible and they would forward it to you and the committee to see. But there has been a drastic improvement and we are moving forward on that. So we'll have those numbers to you in a very short time.

Mr. DAVIS OF ILLINOIS. Well, thank you very much.

Let me ask you, Mr. Blair, what criteria will the Regulatory Commission use for evaluating the quality, completeness, and accuracy of ratemaking data?

Mr. BLAIR. We have approximately 36 years of ratemaking experience in this regard. And we'll use sampling techniques, we look at the statistics. We will also apply special studies of operations using calculations, certain discounts that are recommended by the Postal Service.

Many of the problem areas identified through the annual data submissions by the Postal Service. We are currently in the annual compliance review process. We've asked the Postal Service for certain information, clarifications and updates of certain information, and we are receiving that as we speak. We are also in a—not annual, but a rate review period as well in which we have asked for additional data.

As time goes on we'll develop more and better ways of getting this, but there are certainly areas where studies need to be updated. For instance, city carriers' street time studies can be updated. The region acceptance rates can be updated. And also as the Postal Service implements the new flat sequencing system and employs those sorters, we will need new sortation cost studies. So this is going to be an ongoing area.

I can't emphasize enough, though, how important it is that we have good quality data, and that's something that the Commission has long held, that the quality of the data that we get from the Postal Service is extremely important because it goes into the costing methodologies that were employed in the old ratemaking process. Now it goes into the methodologies that are employed in the compliance process. So we will remain vigilant and constantly monitor the quality of the data that comes out.

Mr. DAVIS OF ILLINOIS. Now let me ask you, as part of its reorganization we understand that the PRC has abolished the Office of Consumer Advocate. Can you tell us how you expect now to make sure that consumer interests and concerns, you know, remain prominent in the process of the ratemaking that will take place?

Mr. BLAIR. We're talking a two-pronged approach on this. We have reorganized to reflect the new reform environment brought about by the enactment of the Postal Accountability Enhancement Act. First, we're mindful that the new law requires the appointment of a public representative in proceedings before the Commission. That's a very important public role.

What we are doing with that is under the old structure, under the Postal Reform Act, that the Commission developed, we had a standing office and that was designed to litigate omnibus cases over a 10-month long case period. The PAEA changed that paradigm. We expect now shorter, more limited, more focused dockets

and significantly pure of major litigated cases. In order to best utilize the resources before the Commission, what we will do is appoint a public representative from among our commission staff offices. That allows us to better pinpoint and target the type of expertise we need to engage in that public representation. We think this will be a better and more effective way than the old structure would have allowed in this new environment.

We've also developed a—we have also implemented an Office of Public Affairs and Government Relations. One of the primary responsibilities of this new office is to interact with the public, field questions, and help resolve informal inquiries regarding the Postal Service. In addition, the Commission will be coming forward over the next few months with new complaint procedures to supplement the current ones that we have in place, and those will be subject to public notice and comment.

Mr. DAVIS OF ILLINOIS. Not that you would have any kind of crystal ball, but given all of the discussions relative to the economic downturns, new ways of doing business, e-commerce, what would you sort of see as a super major challenge of the Postal Service in order to try and keep rates at a level that consumers will be most appreciative of?

Mr. BLAIR. I think there are several fronts that they will be needing to focus on. One will be to keep their labor costs in line. Two, better rationalize their networks. I was listening to the GAO testimony in the anteroom and the GAO provided a good outlook saying that there are some plants that are at over capacity and some are at under capacity. And a better rationalization of that network is important. Good data is needed to rationalize that network. But I think that the Postal Service needs and I know that the Postmaster General is committed to doing more in order to cut costs and better utilize that network.

I think more innovative ways need to be developed in which we keep mailers in the system, be it first class mailers or the ones—the business mailers, the banks, the insurance companies, those major mailers who utilize first class, the flagship product of the Postal Service, keeping them in the system. What can be done to give added value to that mail, to standard mail and also the Postal Service General referenced some new competitive products. The regulator wants to create an environment which is flexible, yet transparent. It will be a balancing act. It is not an easy balancing act either. We want to make sure that there is flexibility there, yet there is the requisite accountability and transparency to the postal pricing and operations that the public demands and deserves.

Mr. DAVIS OF ILLINOIS. Thank you very much.

Let me go to Delegate Norton.

Ms. NORTON. Thank you, Mr. Chairman.

Mr. Potter, you say at page 5, I believe it is, of your testimony that you've identified savings of an additional $1 billion over the $1 billion already built into your savings budget. Where would those savings come from?

Mr. POTTER. They will come from a number of things. First, there will be—there is less mail anticipated.

Ms. NORTON. How is that saving? It sounds to me like loss of business.

Mr. POTTER. It was lost business, but in terms of the budgets that we give, work hours, if there is less mail, then there is less work hours needed. So in terms of a reduction off of the plan, the plan will be reduced to reflect the lighter workload. In addition to that, we're——

Ms. NORTON. I'm not sure private business calls those savings, but I'll take it, Mr. Potter.

Mr. POTTER. OK. In addition to that we're reducing and streamlining our transportation network because we're looking at all of the network and revising the number of trips and the size of the trucks which are all contracted to determine whether or not they are actually needed and whether or not we can streamline the number of trucks. We're about to—this week we've been counting our rural carrier routes as part of our contract. It is going to reflect the fact that there's been a decline in volume on each of those routes since they have been last counted 2 years ago, and so that will result in a reduction in terms of the amount of compensation that those folks are given.

In addition to that, we're looking at the productivity of each and every operation and we're working to improve our efficiency in those operations. So its basically very hard work to try and——

Ms. NORTON. It is very hard work, it is very hard work. You are very fuel and car and truck oriented. You may have heard me asking the previous witness about conversion to alternative vehicles. Are you still using vehicles that largely rely on traditional fuel?

Mr. POTTER. Yes, we are.

Ms. NORTON. Are you doing that even as you have to replace vehicles, as you must have to do quite often?

Mr. POTTER. No, we're not. We have the largest alternate fuel fleet of vehicles in America.

Ms. NORTON. Are those biofuels and ethanol?

Mr. POTTER. Yes. In addition to that we have gas powered vehicles, we have hydrogen vehicles. We're looking at everything that we possibly can and we're testing them all.

Ms. NORTON. There was some feeling that you were constrained in what kind of alternative vehicle you could use. Are you constrained at all in that way any longer after the new energy bill was passed last year?

Mr. POTTER. No. No, we're not. In fact now we are looking—we delayed the replacement of engines and other vehicles of some 150,000 vehicles in anticipation that we would have greater flexibility should that law pass. That law has passed. We now have the greater flexibility. So we're once again looking at what we do with the existing fleet. And we know we have an opportunity to improve——

Ms. NORTON. What's the turnover? How many vehicles do you buy a year?

Mr. POTTER. Well, the last several years we've only bought about 10,000.

Ms. NORTON. You just don't have the money, so you just kept rolling over?

Mr. POTTER. No. About 14 years ago to 17 years ago we bought a fleet of aluminum body vehicles, we call it our long life vehicle, and that vehicle is probably overdue for replacement. About the

last 4 years we should have replaced them. Again we had this energy issue that we wanted to work our way through.

Ms. NORTON. So would you buy any traditional fuel vehicles at this point? If you had to buy one tomorrow, would you be looking exclusively at some kind of alternative fuel vehicle?

Mr. POTTER. Not necessarily exclusive. We buy a myriad of vehicles, from very large trucks to——

Ms. NORTON. So sometimes with very large vehicles you must use——

Mr. POTTER. We would use traditional diesel, we don't have alternatives.

Ms. NORTON. Where are there alternatives?

Mr. POTTER. Where there are alternatives we attempt to buy alternative fuel vehicles.

Ms. NORTON. Do you feel you are under pressure to buy biofuel as opposed to, for example, some of the other——

Mr. POTTER. Not now.

Ms. NORTON. That's very important.

Mr. POTTER. It is. I thank the Congress for helping us with that law. It is extremely important. You have really increased our flexibility, and I'm very appreciative of it. And as I said, we delayed a decision until we determined whether or not we would be able to and we are very grateful for the flexibility.

Ms. NORTON. Very small. There are not many things you can do but to continue to spend money in the good old days or whatever we now want to call them.

I was interested in page 7 of your testimony, where you talk about express mail and priority mail. I just have to congratulate what you report that you have penetrated, gone beyond express mail and priority mail in some respects. You say express mail offers Saturday delivery at regular weekday delivery price. That must match the competition, I take it, because you go on to say and the Postal Service alone is offering Sunday and holiday delivery at this guaranteed overnight delivery price.

Mr. POTTER. If I could explain. With the new law we've gone back and we now have pricing flexibility, so we are looking at ourselves in the marketplace to determine what prices we could charge. And we're looking to try to charge market based prices for the competitive products. We found out we're the only ones who sell Sunday delivery. And so we want to make it clear to all Americans that if you want express mail on Sunday or you want to be able to walk into a lobby and buy it, the place to do it is with us.

Ms. NORTON. Let me ask you, how long have you been doing the Sunday mail?

Mr. POTTER. We've been doing it a long time, but the profit on Sunday mail has been low.

Ms. NORTON. Is that why your competitors are not rushing to get into the Sunday mail competition?

Mr. POTTER. Well, they are not open 24 hours a day like we are with all of our plants from around the country. They have much different operation, much more defined operations.

Ms. NORTON. They are not retail basis, they are not open?

Mr. POTTER. They are not open on a Saturday on a retail basis in a lot of cases, but they don't have 24-hour operations, 365 days

a year necessarily, particularly with express mail. In our case we do and so since we have that infrastructure we try to maximize our opportunity for revenue off that infrastructure. So what we are doing with the new law is we are going to put a surcharge on Sunday delivery, because we have people come in and buy a product on Saturday and they'll request Sunday delivery because it is free. We are the only ones that don't surcharge Saturday delivery. And so since that's a normal day of operation, we are not looking to surcharge Saturday. But since Sunday is an unusual day for us, our carriers aren't out there anyway. We are going to surcharge that and we are going to do it in any market that places or private competitors would do. You charge what the market will bear, and we believe that if the competition puts a surcharge or premium on Saturday delivery, the least we should do as a start is put it on Sunday.

So we are looking forward to additional revenues from those pieces we deliver on Sunday. For those people that don't require Sunday delivery, they'll get their mail delivered on Monday, which they would have done, you know, with others. We are the only ones, as I said, who really have an operation on Saturday.

Ms. NORTON. And since you got it, so you got a volume here that nobody had before, a volume of business that nobody had before?

Mr. POTTER. We had an opportunity to increase the revenue on the business that we have.

Ms. NORTON. Do you lose my money on this?

Mr. POTTER. No, we weren't losing money, but we were not making it. It costs 5.50 cents more to deliver a piece of mail, an express mail piece on Sunday than it does on the rest of the week, and that cuts into our profits on Sunday. And so I think just by raising the price we're going to increase the awareness of the fact that we are doing it. The fact that we didn't have a high profit on Sunday was a motivation not to really be aggressive about selling it. Now that we can sell it and make a profit, a sizable profit, we will be out there in the marketplace and sell it. So we are taking an advantage of the new law that you provided.

Ms. NORTON. Now that you've got the infrastructure and the overhead anyway, maximizing that is—I don't know if you can think of anything else to do with it, but that's terrific.

Mr. POTTER. Thank you.

Ms. NORTON. Finally, let me ask you about the flat rate boxes. You seem to imply, by the way, because you talk about scratching the surface. We just scratched the surface. I'm going to ask, I'm going to have a question. What other kinds of terrific things can you do to keep scratching? But you talk about the new larger priority mail flat rate box. That was a response to that competition that is already doing that?

Mr. POTTER. No. We were the first to have a flat rate box for priority mail, and it was a smaller box. It was extremely popular. We've had a lot of growth in terms of that product. And the competition—one of our competitors matched that and put out a box that's a comparable size and so we recognize that flat rate box is attractive to customers because you pay one price, whatever fits, it works. And so we wanted to give the American public another option. And that's why we went to the larger flat rate box and we ap-

preciate the fact that the Postal Regulatory Commission has approved that, that option. And it begins on March 3rd.

Ms. NORTON. They invited it into their market because they felt the competition. So you upped them because you now are doing a bigger box?

Mr. POTTER. Well, we have a bigger box and that bigger box also has—we tried to respond to a concern of those folks and the families of the folks that we have serving overseas in our military. And we have a discount on that box for military addresses. And so——

Ms. NORTON. Does the competition do that, too?

Mr. POTTER. No. No. And we're very happy and pleased that we're able to do that.

Ms. NORTON. Are you going to do flat boxes on Saturday and Sunday since they can't work at all, since they don't do anything on Saturday and Sunday?

Mr. POTTER. I'll be honest with you. With the downturn in revenue and the concern about diversion to the Internet, we're working very closely with all of our employees, our unions and others to try and generate revenue to support this very vital system that serves each and every American 6 days a week. And I'm really happy with the level of support that everyone has shown the Postal Regulatory Commission. But in particular our employees who are out there and who are going to help spread the word about the fact that they now have the ability to compete and they're anxious to compete and they're anxious to grow revenue.

Ms. NORTON. My final question really is related to this question because I can guarantee you now, they're sitting down right now thinking of a way to take away your Saturday and Sunday business with no—which depends on your infrastructure, depends on your 24-hour service, with no extra cost to them. Depend on it. But if they find a way, they're going to find a way through investment in some kind of equipment. Most of the advances in productivity we see around the world come that way.

What about your capacity? Leave aside the investment that is taking away mail from you or communication vehicles from you. What about your capacity to invest in the kind of equipment needed to move forward to keep up with whatever the competition is doing, especially in these sectors like express mail and the rest?

Mr. POTTER. Well, fortunately for us we have existing capacity, particularly in the delivery area because we are at every door every day. When it comes to plan capacity, the law provides that we have the opportunity to borrow and invest. So it's up to the Board of Governors and postal management to use that authority to invest wisely in the capacity that you describe.

Ms. NORTON. Are you keeping up with the kinds of investments—the delayed gratitude of the private sector is very interesting when it comes to these kinds of investments because they know the payout—they call it all kinds of flexibility to put it on different lines and stuff that you can't do. Do you feel that you are keeping up with this modern technological equipment that the private sector is using and you are able to do so through the authority you have to borrow?

Mr. POTTER. Well, let me speak of it in two ways. When it comes to mail, whether that is solicitation of letter mail or flat mail or

first class mail and advertising mail, the Postal Service, the U.S. Postal Service has the best equipment in world. We are world-class bar none because we've had the scale and the scope of our delivery.

Ms. NORTON. Well, you are losing money.

Mr. POTTER. And unfortunately that's where mail will be diverted or potentially diverted.

Ms. NORTON. Yeah.

Mr. POTTER. On the other hand, when it comes to package service, I will be very honest with you, we are not and have not been investing as aggressively on the mail side, only because of the fact that we didn't have the ability to compete. So if you don't have the ability to compete, you know, you aren't going to make investments. Now that the new law is in place and now that we have the ability to set a plan and know where we're going to be longer term, we're re-evaluating that. And we do have the funds available to us within our borrowing limits. We've borrowed from the Treasury, we have capital program. I'm convinced that we have sufficient funds to make the type of investment that will be needed to compete.

Are we where they are? No. We're behind. But through proper investment, we can catch up and catch up rather quickly.

Ms. NORTON. Borrowing from the Treasury is a great advantage.

Mr. POTTER. Exactly.

Ms. NORTON. Thank you very much, Mr. Chairman. Thank you, Mr. Potter.

Mr. DAVIS OF ILLINOIS. Thank you very much, Delegate Norton.

Mr. Potter, you've mentioned cost cutting, increased efficiency. In the way of cost cutting ideas, what can we expect to hear about?

Mr. POTTER. Well, I'll give you examples of some of the things that we're doing on the competitive side of the aisle. One of the things that we're doing there is just beginning to put the data bases in so that we're tracking productivities by different operations. There's still some areas where we don't have good information systems and simply by tracking them we'll give people—and I'm talking about craft employees as well as managers, you know, information about how well they're doing. And that often is a big motivation. In addition to that, we do have some redundancies in the system and we're looking at minimizing the number of handlings that we have in the system. We're looking at error rates on machines. And we've made some good strides in improving error rates on our machines. We're also looking at the quality of mail that's produced by the mailing community to try and improve the quality of the mail, either through the address and/or the physical piece itself. And by improving that quality, we reduce the number of rehandlings that occur in the system. It's a matter of just tightening up on our processes, making sure that people have the data that they need to manage and understand how well they're performing. In my opinion, it will continue to drive the efficiency of the Postal Service.

Mr. DAVIS OF ILLINOIS. Are we likely to continue to hear much about outsourcing, contracting out?

Mr. POTTER. Well, you won't hear about it from me, but there are others who might comment about it here. But in all candor, we do have ongoing dialog with the NALC and rurals are participating on that panel. As I said, we've extended the moratorium to July 31st.

In addition to that, you referenced earlier the discussion about the request for information that we put out about our network. And we're engaged with the Mail Handlers and the American Postal Workers Union on discussing what options we have. You know, there are some very real business decisions that have to be made. When we look at our end-to-end network on the ground nationwide, we don't have a big demand for that service. In fact, the volume of mail that moves end to end, parcel post on the ground is in a state of decline. That's a product that has a rate cap on it. If the volume declines and we're forced to maintain the current network, we don't see how we're going to be able to stay under a rate cut. If that system's inefficient, it won't be very long before it will be cheaper to fly the mail, which means it will be a high-cost product and no one will use it. There's some very serious business issues and we're sharing those in a very candid way with our employees to try and figure out how we're going to be successful under the new law and meet the requirements of the new law to stay under the rate of inflation and at the same time have a viable product.

We are a challenged business in the sense that every one of our products are being completed. In some cases, there are cheaper alternatives than the Postal Service. People believe services like the Internet are more effective. So I think this is part of the overall kind of evolution of the Postal Service. In the last 200 years there have been a lot of changes. We're at a period of time and again I think we have to have the debate about what are we going to evolve into next.

Mr. DAVIS OF ILLINOIS. Well, let me thank all of you. And let me thank you for the information that you have shared with us. Obviously I was very pleased to hear you talk about the improvements that we have experienced across the board and especially in some particular areas. I just remind you of a story my mother used to tell me, "Good, better and best. Never let it rest until your good becomes better and your better becomes best." And so I guess we keep striving to make sure that we get there.

Finally, as you talked about the cost cutting and savings and figure out how to do it, you reminded me of my father who was a very frugal man. But then he would even get to the point where he would say, "you know, you can't get blood out of a turnip. You can slice it, you can dice it, you can do everything with it. And you still end up with turnip juice." So I recognize the difficulties which our system face.

Thank you, gentlemen, so much for being with us. Thank you all for coming. And this meeting is adjourned.

[Whereupon, at 4:18 p.m., the subcommittee was adjourned.]

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