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U.S. POSTAL SERVICE

Key Postal Transformation Issues

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GAO
Accountability * Integrity * Reliability

GAO-03-812T

Highlights of GAO-03-812T, a testimony before the President's Commission on the United States Postal Service

Why GAO Did This Study

The President established this Commission to examine the state of the U.S. Postal Service (the Service) and submit a report by July 31, 2003, with a proposed future vision for the Service and recommendations to ensure the viability of postal services. GAO has provided congressional committees with many reports and testimonies on postal matters, and this testimony is based largely on these prior reports and testimonies.

In April 2001, GAO put the Service's long-term financial outlook and transformation on its High-Risk List for several reasons. The Service was experiencing

- significant deficits,
- severe cash-flow pressures,
- rising debt,
- cost growth outpacing revenue increases,
- limited productivity gains, and
- liabilities in excess of assets.

Under its 1970s-era business model, the Service was relying on raising rates and incrementally reducing costs to carry out its mission. GAO concluded that this business model was not sustainable in today's competitive environment.

The Commission's report will be an important guide for comprehensive postal transformation. In this testimony, GAO presents key issues the Commission should consider to enhance the long-term financial viability of the Service by making it a more results-oriented and efficient organization.

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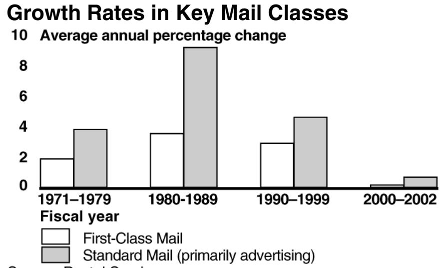
U.S. POSTAL SERVICE

Key Postal Transformation Issues

What GAO Found

The ability of the Service to remain financially viable is at risk because growth in mail volume has stagnated and its business model is not well suited to operate efficiently in a competitive environment. As the figure shows, growth in the volume of First-Class and Standard Mail, the two largest revenue-producing classes, has declined.

Growth Rates in Key Mail Classes



Source: Postal Service.

Key issues for the Commission to consider include the following:

Role and Mission. Over the past 30 years, competition has increased and private-sector firms are performing more traditional postal functions. Customers' needs have also changed with new communication alternatives. In determining what universal postal services are needed and the roles for public and private providers, factors to consider are how to enhance customer convenience and create opportunities for least-cost providers.

Governance Structure and Accountability Mechanisms. Qualification requirements for members of the governing board should ensure that appointees possess the experience needed to oversee a large business-like operation, and the board should have sufficient authority in areas such as setting rates and executive pay. Reporting requirements should ensure accountability and transparency of financial and organizational results.

Flexibilities and Incentives to Increase Revenue and Control Costs. The Service will need appropriate flexibilities and incentives to balance its revenue generation and cost containment capabilities in areas such as allowing retained earnings, closing unneeded post offices, and containing costs related to infrastructure rationalization, workforce realignment, and wage and benefit comparability. Also, the Service's long-term retiree health and workers' compensation obligations need to be addressed.

Effective Labor-Management Relations and Support Systems. To improve operational efficiency and enhance performance accountability for all employees, postal managers and unions need better cooperation to realign the workforce for the future and focus performance management and workforce planning systems on organizational goals and results.

Messrs. Chairmen and Commission Members:

I am pleased to have this opportunity to appear before you to present our views on the transformation of the U.S. Postal Service (the Service). GAO has been involved in reviewing postal issues on behalf of Congress for decades and has issued many reports and testified numerous times before congressional committees on postal matters. My testimony today is based largely on these prior reports and testimonies. (See the section called Related GAO Products at the end of this statement.)

As you know, in April 2001, we put the Postal Service's long-term financial outlook and transformation efforts on our High-Risk List. We did this for several reasons. The Postal Service was experiencing growing financial, operational, and human capital challenges, including declining net income, severe cash-flow pressures and rising debt, increasing competition, and difficulty cutting costs and achieving productivity gains. These challenges were threatening the Service's ability to carry out its mission of providing affordable, high-quality universal postal services on a self-financing basis. Given advances in communications, such as electronic communication devices and the Internet, increasing domestic and foreign competition, changes in the growth of mail volume, and the need to serve more and more addresses yearly, we were concerned that the Postal Service would have difficulty in effectively carrying out its mission in the future. We were also concerned because the Service did not have a comprehensive transformation plan to guide it in the future, and because the significant shift in the Service's financial outlook came as a surprise to many key stakeholders. In fall of 2001, the Service's financial situation became even more complex and critical due to the events of September 11th and the subsequent use of the mail to transmit anthrax.

Consequently, we called for a number of actions to address our concerns about the Postal Service's financial situation and long-term outlook. We recommended that the Postal Service develop and implement a comprehensive transformation plan that would lay out actions it could take under existing law, actions that would require incremental legislative action to help address the Service's more immediate financial difficulties, and comprehensive legislative action to address key unresolved transformation issues. We also suggested that Congress consider various approaches to addressing long-standing and difficult-to-resolve issues affecting the Postal Service's financial situation, such as by establishing a commission to study the issues and make recommendations.

We are pleased that the President established a Commission to examine the state of the Postal Service and submit a report to the President by July 31, 2003, that would propose a vision for the future of the Service and recommendations to ensure the viability of postal services. We have previously provided this Commission with a number of GAO reports, testimonies, and other information related to the Postal Service and offer our assistance to the Commission as it completes its work. We look forward to the Commission's report and believe it will be an important guide for Congress as it considers comprehensive postal transformation. In this testimony, I will discuss four key issues the Commission should consider to address deficiencies in the Service's business model and enhance the Service's long-term financial viability by making it a more results-oriented, efficient organization. These areas include the Service's (1) role and mission, (2) governance structure and accountability mechanisms, (3) flexibilities and incentives to increase revenue and control costs, and (4) effective labor-management relations and support systems to improve organizational efficiency.

Short-Term Financial Pressures Have Been Alleviated but Fundamental Issues Remain

The Service has responded to a number of our concerns and taken actions to address its short-term financial challenges. In April 2002, the Service published its Transformation Plan and has begun to implement it. The Service has also taken actions to control costs by reducing the size of its work force and labor hours usage and by improving productivity. In fiscal year 2002, the Service reported that, for the first time in over 30 years, its operating expenses were reduced below those of the previous year. Furthermore, in large part based on an Office of Personnel Management (OPM) study undertaken at the request of GAO, legislation was passed in April 2003 that enabled the Postal Service to reduce its pension cost by about $3 billion per year over the next few years.

These incremental steps, although useful, cannot resolve the fundamental and systemic issues associated with the Service's current business model. The Postal Reorganization Act of 1970 (P.L. 91-375) provided the legal framework for the Service's current business model. In passing the Act, Congress intended the Service to operate in a business-like manner. However, in contrast, the Act also included such provisions as monopoly protections on letter mail and access to mailboxes, a mandate to break even financially over time, and a rate-setting process that is based on specific cost-coverage requirements—often referred to as "cost-of-service regulation." Furthermore, the Act generally did not envision the extent to which the Postal Service would be directly competing with private-sector companies. As such, the Service's current business model, which relies on increasing mail volumes to finance universally available postal services through an expanding delivery network, is outmoded in today's rapidly changing and increasingly competitive business environment.

Today, businesses and consumers have many more communications and delivery choices than they did 30 years ago. New types of electronic communication devices include E-mail, cell phones, fax machines, and electronic bill payment services. There is also greater competition in the mail and package delivery markets. These market changes have been driven by the need for more time-sensitive movement of products and services, as well as the ability to track products and services throughout the delivery process from origin to destination.

These changes in the postal marketplace have highlighted the following fundamental issues with the Service's business model:

- The Service's ability to remain financially viable under its current business model is at risk as the growth in mail volumes has stagnated or declined, leading to less revenue unless rates are increased. Further, it has been estimated that about 45 percent of the Service's mail delivery routes do not generate adequate revenue to cover their costs.

- The Service does not have the flexibilities or incentives necessary to operate efficiently in a highly competitive environment. This is particularly important because the Service has historically not been able to significantly control and/or reduce costs in its two major cost areas: employee-related costs, which continue to account for over three-quarters of the Service's total operating expenses, and overall infrastructure costs for the Service's retail and processing networks.

- Long-standing adversarial relationships between postal managers and labor unions have hindered efforts to increase efficiency and create a more results-oriented culture that would help achieve long-term financial viability for the Service, along with a fair and positive work environment for employees.

Fundamental changes will need to be made to the Service's business model, and the legal and regulatory framework that supports it, to provide for the Service's long-term financial viability. The Postal Service's short-term financial relief provides a limited window of opportunity to bring about this fundamental change. The time has come to take bold and comprehensive action designed to transform the Postal Service to meet the challenges and new realities of the 21st century. This will involve actions by both the executive and legislative branches of government as well as a variety of other postal stakeholders.

Today, I will direct my comments to the following four areas that will be critical to addressing problems with the Service's current business model and ensuring its future financial viability: (1) role and mission, (2) governance structure and accountability mechanisms, (3) flexibility and incentives to increase revenues and control costs, and (4) the link between labor-management relations and improving operational efficiency.

Role and Mission

Over the years, postal stakeholders have raised numerous issues regarding the Service's role and mission relative to the private sector. Among these issues are the following:

- How should universal postal service be defined given past changes and future challenges?
- Should the Service remain a government entity or should it be wholly or partially privatized?
- Is a government monopoly needed to provide universal postal services? Should the Postal Service's monopoly protections be reduced or eliminated, and if so, how should a minimal service level be ensured?
- Should the Service retain its governmental functions, including regulatory responsibilities related to protecting the mail monopoly and the integrity of the mail, as well as its law enforcement functions related to mail fraud, security, and theft?
- To what extent should the Postal Service, the mailing industry, and other private-sector companies perform various postal functions, such as collection, processing, transportation, and retail services? Should additional worksharing be encouraged, and how should long-standing cost issues be resolved?
- Should the Service be allowed to compete in areas where there are private-sector providers? If so, on what terms, and what transparency and accountability mechanisms are needed to prevent cross subsidies between competitive and monopoly products and services?

Universal Postal Service

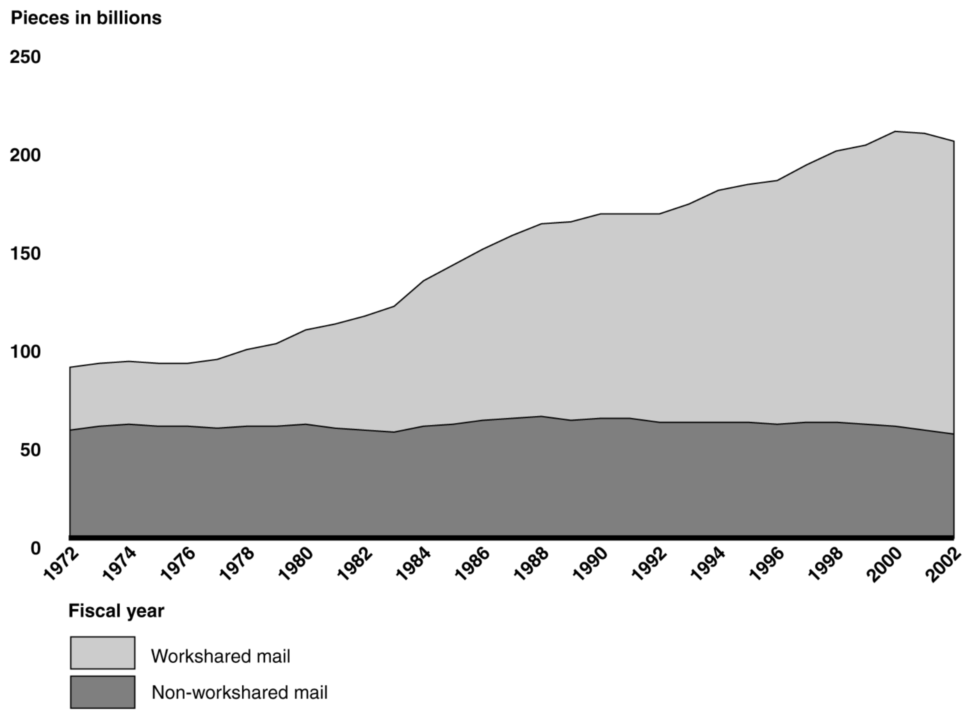
The Postal Service's current mission is to provide access to universal postal services in all communities at reasonable rates. Universal postal service is not defined in law, but the Service's interpretation of this responsibility has evolved throughout its history to accommodate changing customer demands. Currently, universal postal service includes a uniform rate for one category of mail, 6-day per week mail delivery, and access to postal retail services. Vast changes in communications and delivery options, as well as the growth of the related competitive environment, over the past 30 years are continuing at a rapid pace. These changes provide an impetus for reconsidering what universal postal service will be needed for the 21st century. Such considerations should include recognition of different needs for different customer segments. As the mail stream has evolved away from personal correspondence and towards more advertising mail, the need for uniform rates and service may be changing. In addition, access to postal services involves many more options today, such as vending machines, ATMs, and grocery stores, which could reduce reliance upon traditional post offices and improve service.

Postal, Government, and Private-sector Functions

Once the scope of universal postal service is addressed, the next questions relate to whether core postal functions should be discharged by a public entity, private companies, or a combination of both. The current statutory framework provides the Service with a monopoly on letter mail and access to mailboxes to fund universal postal service. The Service generally carries out its mission by collecting, transporting, processing, and delivering mail to addresses throughout the United States and to foreign postal administrations for deliveries to addresses outside this country. In addition to its retail services and mail delivery roles, the Postal Service is also charged with governmental functions for enforcing federal laws related to mail fraud, security, and theft.

Since the 1970 reorganization, the Service's role has changed as it has engaged the private sector in postal activities in several ways. For example, the Service has (1) arranged for private entities, such as grocery stores, to sell stamps; (2) increased its contracting with private firms to transport mail; and (3) offered worksharing rates, which include discounts to mailers to carry out certain mail processing operations, such as presorting, barcoding, and transporting mail directly to Postal Service facilities for delivery by the Service to its customers. The purpose of these activities has been to increase customer convenience, cut Postal Service operating costs, and create the opportunity for the least-cost provider to perform certain postal activities. For example, as shown in figure 1, mail volume growth since fiscal year 1972 has been in workshared mail. In fiscal year 2002, nearly three-quarters of the Postal Service's mail volume consisted of mail that involved some aspect of worksharing.

Figure 1: Growth in Workshared Mail Volume Between Fiscal Years 1972 and 2002



Source: GAO analysis of Postal Service data.

Note: Workshared mail receives a lower rate due to such mailer activities as presorting, bar coding, and destination entry. Most Standard Mail and Periodicals volumes were counted as workshared beginning in fiscal year 1971 because the Service required presorting of this mail by Zip Code and such worksharing was recognized in its postal rates. Worksharing rates for First-Class Mail were introduced in fiscal year 1977.

A number of issues have been raised related to whether the worksharing rates accurately reflect the Service's estimated cost savings from mailer worksharing activities. We are currently assessing these issues and plan to issue a report later this year.

At the same time, the Service's involvement in what is often called "nonpostal" or "nontraditional" areas has also been controversial. These nonpostal activities refer to new products or services that generate revenues and are not directly related to the Service's core postal activities. Nonpostal activities are not subject to the same regulatory scrutiny by the Postal Rate Commission (PRC) that postal activities currently face. Some examples of nonpostal activities include electronic billing and payment services, as well as electronic greeting cards. As we discuss later, we have reported on the Service's difficulties in meeting its performance goals related to nonpostal activities and about controversies regarding the Service's involvement in nonpostal activities that are also provided by private-sector companies. Recently, the Service discontinued some of its nonpostal activities, but it remains a valid question as to whether the Service has the appropriate incentives, transparency and accountability mechanisms, cost-structure, and marketing skills to succeed in nonpostal-related areas.

Governance Structure and Accountability Mechanisms

Key issues have been raised about whether the Service's current governance structure and accountability mechanisms are sufficient for an organization with annual revenues approaching $70 billion and over 850,000 employees. Some of the issues relate to the Board of Governors' limited authority in areas such as setting postal rates and executive pay; qualifications requirements that are too general to ensure that Board appointees possess the kind of experience necessary to oversee a major government business; and limited transparency and accountability mechanisms for organizational performance and results. If the Service is to successfully operate in a more competitive environment, the role and structure of a private-sector Board of Directors may be a more appropriate guide in this area.

Having a qualified and independent board is important to ensuring that the board can play a significant role in the following three areas:[1]

- First, boards should provide strategic advice to management in order to help comply with overall statutory requirements and realize organization goals.
- Second, boards need to help manage risk, including risk related to attempts to maximize current value at the expense of mortgaging the future. Risk management must also consider the interests of key stakeholder groups, such as employees, customers, and the communities in which the organization operates.
- Third, boards have a clear responsibility to hold management accountable for results.

[1]U.S. General Accounting Office, *Major Management Challenges and Program Risks: U.S. Postal Service*, GAO-03-118 (Washington, D.C.: Jan. 2003).

The Service is not subject to the same level of transparency and accountability mechanisms as other "business-like entities," such as private-sector companies, that regularly report to shareholders and/or regulators (e.g., the Securities and Exchange Commission). Some important issues to consider include what regulatory structure and oversight mechanisms may be needed, to whom the Service should be accountable, and what appropriate mechanisms are needed for consumer protection—particularly for those with few or no alternatives to the mail system? Concerns have also been raised about the need to provide accountability for performance, especially in areas where the Service is provided with additional flexibility. As we have reported in the past, many concerns have been raised about areas where the Service has had flexibility, such as the international and new products areas, and its financial performance has not met its stated goals and objectives.[2] Further, if the Service is allowed to compete, should it be subject to the same laws and regulations as its competitors? If the Service retains some monopoly protections while also providing competitive products, steps will be needed to ensure that products are not being cross-subsidized.

Another key question involves determining what level of transparency through public reporting on the Service's financial and operating performance, as well as its progress in implementing its transformation, is appropriate. We have reported concerns about the Service's public reporting in the following areas: retiree health benefit obligations; periodic financial reporting; nonpostal new products and services, including e-commerce initiatives; annual performance reporting as required under the Government Performance and Results Act (GPRA); and the status of implementing initiatives from its Transformation Plan.[3] Our concerns related to the Service's reporting on its retiree health benefit obligations are discussed in more detail later in this statement.

[2]U.S. General Accounting Office, *U.S. Postal Service: Update on E-Commerce Activities and Privacy Protections*, GAO-02-79 (Washington, D.C.: Dec. 21, 2001); *U.S. Postal Service: Postal Activities and Laws Related to Electronic Commerce*, GAO/GGD-00-188 (Washington, D.C.: Sept. 7, 2000); *U.S. Postal Service: Development and Inventory of New Products*, GAO/GGD-99-15 (Washington, D.C.: Nov. 24, 1998).

[3]U.S. General Accounting Office, *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). See also GAO-02-79, GAO-00-188, and GAO-03-118.

Regarding the Service's periodic financial reporting, we reported in November 2002 on the lack of sufficient and timely periodic information on the Service's financial condition and outlook available to the public between publications of its audited year-end financial statements.[4] Since our report was issued, the Service has taken steps to improve this information, including making its quarterly financial reports available on its Web site. However, we continue to have concerns about some of the Service's financial and performance information, including information related to its e-commerce and other nonpostal activities, as well as the lack of delivery performance information for all of its major mail categories. In order to determine whether further changes in financial reporting are needed, the Commission should consider the SEC reporting requirements as a possible guide in this area. In addition, other current reporting mechanisms, such as the Service's annual performance reports required under GPRA, could be adapted to communicate the Service's delivery performance for all of its major mail categories, as well as update its progress on implementing its Transformation Plan.

Flexibilities and Incentives to Increase Revenues and Control Costs

The Service has limited financial incentives under its current business model with its break-even mandate and cost-of-service rate-setting structure. To enhance its long-term financial viability in a competitive environment, the Service will need appropriate flexibilities and incentives to balance its revenue generation and cost containment capabilities. The Postal Service argues that it has difficultly raising revenue under the lengthy rate-setting process, which does not allow the Service to change its prices in a timely manner to respond to changing economic conditions. The Service indicated that it would like additional flexibility in connection with retaining earnings, setting rates, and developing and promoting new products and services. These flexibilities could enhance its revenue-generating capability and help offset continued anticipated volume declines. However, these flexibilities will need to be coupled with reasonable transparency and appropriate accountability mechanisms to prevent abuse.

The Service also does not have adequate flexibility to address its cost structure, especially in the areas of infrastructure rationalization and workforce realignment. Furthermore, cost issues related to compensation and benefits, including its workers' compensation obligations and its long-

[4] See GAO-03-26R.

term retiree health obligations, need to be addressed. The Commission will need to consider what flexibility and incentives are appropriate to allow the Postal Service to make changes in its revenue and cost structure to reflect changing economic conditions and improve its efficiency in an increasingly competitive environment.

Break-even Mandate

Although the Service's break-even mandate was established to foster reasonable rates, this mandate removes the profit motive. In its Transformation Plan, the Service proposed a revision to its break-even mandate that would permit it to retain earnings. Key questions for consideration include the following:

- Could the Service remain self-supporting under its mandate to break even over time?
- Should the Service's business model be adjusted to allow some additional flexibility to retain a reasonable level of earnings?
- Would changing the Service's break-even mandate lead to a reduction in the quality and scope of universal postal service?

To address concerns about potential service reductions, some other countries, such as Germany and the Netherlands, whose postal administrations operate on a for-profit basis, have imposed specific minimum requirements for universal postal service and added regulatory oversight in connection with the quality of postal service.

Rate-setting Structure

The Service's cost-of-service rate-setting structure allows the Service to cover rising costs by increasing rates. The rate-setting process was created to ensure prior independent review of Service-proposed domestic postal rates and fees. It also includes due process for all interested parties in hearings on the record. This process has led to proceedings that are often lengthy and adversarial. Although the current system was designed to enable the Service to break even over time, in practice the Service has accumulated significant prior years' losses and debt and has had difficulty funding capital investments without borrowing. Some of the key questions related to the current rate-setting process include the following:

- Should the current rate-setting process be retained, modified, or replaced with a different system? Are changes to the current rate-setting structure needed to provide sufficient funds for the Service's operating and capital needs and to repay debt? Should the Service's rate setting be subject to prior regulatory review?

- What should be the respective authorities and responsibilities of the Service and any independent regulator, including the authority to compel provision of information and final decision-making authority over what rates are set?

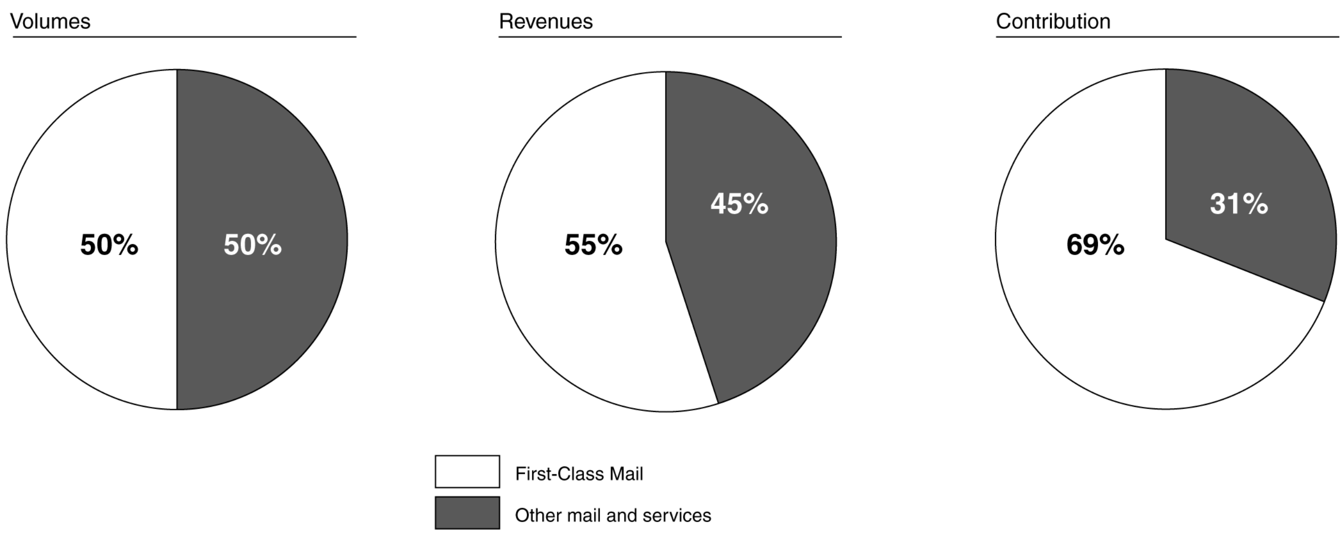
- Should legal requirements that affect rates—including that each mail class cover its costs, and preferred rates for certain groups—be retained, changed, or eliminated?

Consensus on these issues will be difficult to achieve, but improvements in the rate-setting structure will be a fundamental component of a comprehensive transformation. One innovation in the rate-setting process that was recently approved by the PRC on an experimental basis was the Service's proposal for a negotiated service agreement (NSA). An NSA is a customer-specific agreement with the Service, whereby the customer agrees to perform specified mail preparation activities; and if the customer's total mailings exceed a pre-set volume threshold, then the customer receives a discount rate and/or predetermined services. The Service anticipates that such agreements will result in additional volume and revenue.

Revenue Generation

The key financial challenge facing the Service is whether it will be able to generate sufficient revenues to cover its costs in the face of stagnating or declining mail volume growth. Some of the limitations in the Service's current business model related to its revenue-generating capacity have become more evident as mail volumes have recently declined in major mail classes, particularly in First-Class Mail. The overall growth rate for First-Class Mail has been trending downward for about 20 years. These declines are significant because, as seen in figure 2, the revenue generated from First-Class Mail is used to cover about 69 percent of the Service's institutional costs. The Service's institutional costs comprise nearly 40 percent of its total costs.

Figure 2: First-Class Mail Volume, Revenue, and Contribution to Institutional Costs in Fiscal Year 2002



Source: GAO analysis of Postal Service and Postal Rate Commission data.

As seen in table 1, the loss in contribution from declining First-Class Mail volume would be difficult to recover from other classes of mail.

Table 1: Additional Volume Increases that Would be Necessary to Recover Loss in Contribution From a 1 Percent Decline in First-Class Mail Volume

Type of mail	Volume increase necessary	Actual volume change between fiscal years 2001 and 2002
Priority	14%	(11%)
Express	43%	(12%)
Standard	3%	(3%)
Package Services	116%	(2%)

Source: GAO analysis of Postal Service and Postal Rate Commission data.

As part of its Transformation Plan, the Service stated that it would like to generate revenues from new products and services, and it has requested additional flexibility in this area. Many questions, however, have been raised about the Service's ability to generate revenues to cover the costs from its new products and services. This area has been the source of much controversy, particularly related to whether the Service is or should be allowed to enter into markets where private-sector companies are operating, and whether these products and services are being cross-subsidized by monopoly-protected postal products and services. We have issued several reports regarding the Service's activities related to new products and services.[5] We have consistently found that the Service's performance did not meet its stated goals, and that it did not have appropriate financial information and controls in this area. Although it was not possible for us to determine the extent of any cross-subsidy due to incomplete financial information, it was clear that, as of fiscal year 2002, the Service was not generating sufficient revenues to cover its costs related to these new product areas.

Another revenue-generating opportunity discussed in the Transformation Plan is leveraging existing assets and infrastructure, such as postal-owned vehicles, facilities, and its nationwide 6-day-a-week, last-mile delivery network. Further explorations of opportunities related to its existing assets could potentially provide additional revenue. As part of its Transformation Plan, the Service has stated that it may have the capacity to generate revenue by offering access to available space in warehouses and vehicles.

Cost Restrictions

Clearly, one of the fundamental deficiencies in the current business model is that it does not provide appropriate incentives to operate in the most cost-effective manner. The cost-based rate structure, monopoly protections, and break-even mandate provide limited incentives for the Service to control costs, particularly in its two largest cost areas—infrastructure and workforce. The Service's extensive infrastructure network has evolved piecemeal over time and may not reflect the most efficient operating structure. The Service may be able to operate more economically and efficiently by consolidating a number of its processing facilities. Many concerns have also been raised about the efficiency of the Service's retail network, consisting of thousands of post offices, branches, and stations. In the workforce area, employee wages and benefits comprise about three-quarters of the Service's total operating expenses. This percentage has not changed dramatically over the last 30 years, despite numerous automation initiatives undertaken by the Service.

Some of the key questions that relate to improving the Service's efficiency include the following:

[5] See GAO-02-79, GAO/GGD-00-188, and GAO/GGD-99-15.

- What is the optimal size and composition of the Postal Service's infrastructure and workforce? What service levels should be provided?

- What impediments limit the Service's ability to sustain long-term efficiency and productivity improvements, such as standardization of its processing plants?

- Should current restrictions on closing or consolidating post offices be changed to facilitate optimizing the Service's retail network?

- How should mail safety and security considerations be incorporated into the Service's network optimization plans? Should operations be redesigned to accommodate mail security concerns, particularly for high-risk "unknown" sender or collection mail? What are the costs and who should pay for mail security enhancements?

Infrastructure Optimization

A key to becoming a more cost-effective and efficient organization will be to rationalize the Service's infrastructure to better support its future operations. A wide variation exists in the efficiency levels across mail processing plants, and the Service does not have standardized operations throughout its nationwide network of processing plants. According to postal officials, in some areas it is difficult to achieve efficient operations due to plant layouts or locations. For example, in some older facilities processing operations are spread over multiple floors or span several buildings, while many of the newer plants are laid out on one floor to better accommodate the automated equipment used today. In addition, the location of some plants, such as those in big cities, may hinder operations because of surrounding traffic congestion. On the retail side, the Service has estimated that many of its post offices are not profitable and many of the transactions that take place at a post office, like selling stamps, can be conducted more efficiently through other retail alternatives.

Currently, the Service is analyzing the optimization of its retail function and has begun to put additional emphasis on using means other than post offices to provide retail services to its customers. In addition, the Service is studying the optimization of its mail processing and transportation network. According to the Service's Transformation Plan, its strategy for optimizing its mail processing and transportation network was to have been developed by fall of 2002. However, recently postal managers told us that the Service is still in the process of developing its overall concept and strategies for its revised network and anticipates that it will release its initial plans in January 2004. We are reviewing the Service's approach to its network optimization study and will report later on the results of our review.

The Postal Service's infrastructure includes a variety of structures, including over 300,000 collection boxes, 38,000 post offices, stations, and branches, 500 mail processing plants, and various other types of facilities. The Service delivers mail to over 140 million business and residential addresses, including individual mailboxes, cluster boxes, and post office boxes. As of October 2002, it reported having 115 facilities or land parcels that were vacant or underutilized. The federal government's real property area is a new area that GAO has recently identified as high-risk.[6] Long-standing problems with excess and underutilized property, deteriorating facilities, unreliable real property data, and costly space are challenges shared by several agencies. These factors have multibillion-dollar cost implications and can seriously jeopardize mission accomplishment. Rationalization of any excess infrastructure can also result in additional cash from sales proceeds.

Historically, closing and consolidating post offices and processing plants has often been controversial on account of worker, community, and congressional interests. The Service's current business model includes statutory restrictions that limit its ability to close and/or consolidate post offices. We have reported that the Service has faced resistance to closures because of the potential effects on jobs and mail delivery service to local communities.[7] Given the controversy that surrounds closure of postal facilities, some mechanism, such as the military base-closure process, may be needed. Once agreement is reached on closing/consolidating postal facilities, steps would need to be taken to help ensure that unneeded postal properties are promptly and appropriately handled.

Furthermore, safety and security concerns will need to be considered as part of the Service's network optimizing efforts. At the request of the House Committee on Government Reform, we held a conference on issues related to mail security in December 2001 and issued a report on the

[6] U.S. General Accounting Office, *High-Risk Series: Federal Real Property*, GAO-03-122 (Washington, D.C.: Jan. 2003).

[7] U.S. General Accounting Office, *U.S. Postal Service: Deteriorating Financial Outlook Increases Need for Transformation*, GAO-02-355 (Washington, D.C.: Feb. 28, 2002).

concerns and suggestions that resulted from that conference.[8] Some of the conference discussion revolved around whether separate processing operations would be needed for mail streams with different levels of risk. For example, mail from collection boxes is deemed to be higher risk because the sender is unknown, while much of the bulk business mail is considered lower risk because it is from known shippers. The Service will need to determine whether it should place biohazard detection equipment in all processing plants or establish separate processes for various levels of risk in the mail stream. Another related issue is who should pay for costs related to enhancing mail security—ratepayers, taxpayers, or both. To date, the Postal Service has received $762 million in appropriated funds to cover costs associated with the anthrax and terrorist attacks. The Service requested another $350 million in its fiscal year 2004 appropriations request for emergency preparedness costs.

Workforce Size, Composition, and Costs

In the workforce area, the Service has significant unresolved cost issues related to

- wage and benefit premiums associated with some of its employees whose compensation is determined through collective bargaining;
- compensation limitations for executives subject to executive pay caps;
- impact on Service costs of recent legislation requiring the Service to cover pension costs for the time its employees served in the military;
- rising health care costs for current and retired employees;
- impact on Service costs of not accruing its retiree health benefit costs; and
- growth in workers' compensation costs.

We recognize that the Service's recent workforce reductions have resulted in some cost savings. However, achieving more significant savings in total costs will require further reducing the size of its workforce and examining its current compensation and benefits arrangements, including workers' compensation. Further, the Service should revisit the accounting and funding treatment of its long-term retiree health obligations. In fiscal year 2002, the Service had over 854,000 total employees, and the compensation

[8] U.S. General Accounting Office, *Highlights of GAO's Conference on Options to Enhance Mail Security and Postal Operations*, GAO-02-315SP (Washington, D.C.: Dec. 20, 2001).

and benefit costs for these employees amounted to about $53 billion. About 90 percent of the Service's 750,000 career employees are covered by collective bargaining agreements.

Wage and Benefit Comparability

One of the most difficult challenges that the Service faces is making changes to its compensation systems. The Postal Service is required by statute to provide its employees with wages and benefits comparable to those of private-sector employees, but it faces several problems in this area. On the one hand, postal officials have stated that the statutory pay cap for postal executives has limited its ability to provide compensation that is comparable to that in the private sector for selected managerial, executive, and officer level positions. This restriction may make it more difficult for the Service to recruit and retain key executive talent. On the other hand, the Commission heard testimony from Professor Wachter at its hearing in Chicago that postal employees whose pay is set through collective bargaining have a significant wage and benefit premium over comparable private-sector employees.[9] This premium was estimated to be 34.2 percent in the 2000-2001 interest arbitration proceeding between the Postal Service and the American Postal Workers Union, which covers approximately 366,000 employees.

The issues of wage and benefit comparability and factors that need to be considered under the collective bargaining process are fundamentally important to the Service's future transformation efforts. As the Postal Service noted in its testimony before the Commission, the cost of postal benefits has risen about 27 percent more than those of the private sector in the last 20 years. The Service also testified that there are substantial fringe benefit costs (retirement and retiree health care benefits) that are statutorily mandated, and thus outside the scope of collective bargaining. The Commission has also heard that the Service's costs for some employee benefits within the scope of collective bargaining—those for health benefits for active employees—are higher than those in the private sector as well as other federal agencies. For example, the Postal Service pays about 85 percent of its employees' health benefit premiums, while other federal agencies pay up to 75 percent of these costs. Furthermore, we believe the fact that the Service pays a higher percentage of its

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[9] See *Statement of Michael L. Wachter,* Before the President's Commission on the United States Postal Service, April 29, 2003. Professor Wachter is a professor of Law and Economics at the University of Pennsylvania. He has consulted for the Postal Service since 1981 and testifies on its behalf in interest arbitration panels on issues involving Postal Service wage and benefit comparability.

employees' insurance premiums and continues to pay a portion of the premiums after retirement is an important consideration in assessing the total wage and benefit comparability of postal employees.

Although the parties disagree about whether a wage and benefit premium exists and about the basis for making these comparisons, the Service's ability to control costs in this area will be critical to achieving a more efficient organization. One of the limitations in the existing collective bargaining process is that the interests of all postal stakeholders, such as ratepayers, do not appear to have been sufficiently considered. As a starting point, the Commission may want to revisit the guiding principles incorporated into the wage and comparability standard so that it would more fully reflect all stakeholder interests and the Service's overall financial condition and outlook. These principles could include the full compensation and benefit costs, as well as the relationship of these costs relative to total costs, impact on rates and revenues, and the Service's overall financial condition. In addition, postal labor and management have disagreed on the benchmarks that should be used in making total compensation comparisons. For example, questions exist as to whether the private-sector comparison group should be unionized workers, non-unionized, or some combination thereof, and whether the total value of benefits has been factored into this comparison. It may be beneficial for any legislation requiring compensation comparability to include specific criteria and factors upon which a comparison must be made.

Workers' Compensation Costs

Another benefit area where costs have been difficult to control is the Service's workers' compensation benefits. This presents a significant challenge to the Service, because these costs totaled $1.5 billion in fiscal year 2002, an increase of over $500 million, or 50 percent, from the previous year. In addition, the Service's total liability for its workers' compensation benefits amounted to $6.7 billion at the end of fiscal year 2002. The Service attributed the cost increases to a record number of compensation claims filed and a rise in the average cost per medical claim. While we have not reviewed the reasons for the cost increases, we believe that the significantly increased costs warrant attention by the Service.

In addition, the Commission may want to consider the comparability of the Service's workers' compensation benefits as it considers the Service's total compensation and benefits for postal employees. Several GAO reports have raised issues about benefit payment policies under the Federal Employees' Compensation Act (FECA), including how these benefits compare to those of other federal and state workers' compensation laws and changing benefit payments for retirement-aged beneficiaries.[10] In April 1996, we reported on our comparison of benefits authorized by FECA with those authorized under the Longshore and Harbor Workers' Compensation Act and state workers' compensation laws. [11] We found that, in general, FECA provided the same types of benefits to injured federal workers as those provided under other federal and state workers' compensation laws; however, there were three principle ways in which FECA benefits were more generous:

- FECA's authorized maximum weekly benefit amount was greater;
- FECA provided claimants who had a spouse and/or dependent with an additional benefit of 8-1/3 percent of salary; and
- FECA provided eligible federal workers who suffered traumatic injuries with additional salary continuation benefits for a period not to exceed 45 days.

We have also reported on possible changes to FECA benefits for beneficiaries who are at or beyond retirement age.[12] We noted that older FECA beneficiaries made up a high percentage of cases on the long-term rolls and accounted for a substantial portion of the FECA benefits paid for long-term compensation. We identified two prior proposals for reducing FECA benefits to those who become eligible for retirement. One would convert compensation benefits received by retirement-eligible injured workers to retirement benefits. However, this approach raises complex issues related to changing workers' compensation benefits to taxable income and allowing for varying amounts of retirement benefits. The second proposal would convert FECA benefits to a newly established FECA annuity, thus avoiding the complexity of shifting from one benefit program to another. To help address FECA-related cost issues, the Commission and Congress could consider converting from the current FECA benefit structure to a FECA annuity.

[10]U.S. General Accounting Office, *Recent GAO Reports on the Federal Employees' Compensation Act*, GAO/T-GGD-97-187 (Washington, D.C.: Sept. 30, 1997).

[11]U.S. General Accounting Office, *Workers' Compensation: Selected Comparisons of Federal and State Laws*, GAO/GGD-96-76 (Washington, D.C.: Apr. 3, 1996).

[12]U.S. General Accounting Office, *Federal Employees' Compensation Act: Issues Associated With Changing Benefits for Older Beneficiaries*, GAO/GGD-96-138BR (Washington, D.C. Aug. 14, 1996).

Pension and Retiree Health Obligations

Recent statutory changes in how the Service funds its Civil Service Retirement System (CSRS) pension costs will result in substantial financial savings to the Service. Those savings represent an opportunity for the Service to address its significant financial challenges, including its large unfunded retiree health obligation. While the pension obligation is being funded as benefits are earned and recovered through rates, the retiree health obligation is not. The health obligation is also not reflected in the Service's financial statements. Recent estimates put the present value of the Service's retiree health obligation at between $40 and $50 billion. Under the Service's current rate-setting method, the increasing cost of these obligations will result in sharply escalating future rates. The Commission could be instrumental in guiding the Service on how best to address this and other major financial management challenges as the Service strives to transform itself.

In April 2003, the President signed into law the Postal Civil Service Retirement System Funding Reform Act of 2003 (P.L. 108-18). The Act was the culmination of an analysis we requested in May 2002 that the Office of Personnel Management (OPM) perform on the extent to which the Service had funded and was projected to have funded the CSRS costs of its employees and annuitants.[13] In November 2002, OPM reported that, based on the level of contributions set forth in what was then the current law, the Service would overfund its pension obligation by $77.7 billion. However, OPM's calculation assumed that the Service was responsible at that time for funding the cost of military service of applicable Service employees, which was consistent with the administration's legislative proposal. According to OPM, the administration's legislative proposal was modeled after the other major federal retirement system, the Federal Employee Retirement System (FERS), whereby the agencies fund benefits related to military service. Because under then current law this military funding was the responsibility of Treasury, we asked OPM to recalculate this overfunded amount, excluding the benefits attributable to military

[13]These costs are those attributable to service rendered since the July 1, 1971, effective date of the Postal Reorganization Act.

service, and found that it was actually $104.9 billion.[14] Measured on a present value basis as of September 30, 2002, this shift in military service cost amounts to over $27 billion. (See appendix for additional details on these calculations.)

P.L. 108-18 did in fact make the Service responsible for funding these military costs. The Act also changed how the Service funds its CSRS pension costs and, in so doing, reduced its payments to the Civil Service Retirement and Disability Fund (CSRDF) by an average of over $3 billion per year over the next 5 years and the full $77.7 billion over the next 40 years to prevent any overfunding from occurring. Furthermore, Congress acted on our suggestion to consider the Service's $11 billion in outstanding debt to the federal government and directed the Service to apply the savings in fiscal years 2003 and 2004 that result from enactment of this legislation to reducing its debt. The legislation also requires that the Service submit a proposal to the President, Congress, and GAO detailing how savings attributable to any fiscal year after 2005 and held in escrow should be expended, including for debt repayment, pre-funding its retiree health obligation, productivity and cost saving capital investments, delaying or moderating postal rate increases, or any other matter. GAO has 60 days from the time it receives the Service's report to submit a written evaluation of it. Furthermore, we are beginning work on developing various alternatives for funding the existing unfunded retiree health obligation and future costs. Without a major change in its funding approach, this obligation will exacerbate the Service's financial problems in the future.

The law also requires the Service to consider your work in formulating its plan for the savings. Accordingly, we believe that the issue of how the Service currently accounts for and funds its retiree health benefits needs to be seriously considered as part of any effort to address the future viability of the Postal Service and should be factored into the Commission's deliberations.

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[14]Until passage of P.L. 108-18, Treasury funded the cost of military service creditable towards a CSRS benefit not otherwise paid for by employees. The Act shifted responsibility for funding military service costs from the Treasury to the Postal Service – retroactive to July 1, 1971, and prospectively. However, the Act also requires the Postal Service, the Treasury, and OPM each to review this provision and submit proposals by September 30, 2003, detailing whether and to what extent the Treasury or the Postal Service should be responsible for funding these benefits in the long term. GAO has 60 days from the time it receives these reports to submit a written evaluation of them to the House and Senate oversight committees.

Unlike its CSRS pension obligation, which the Act put on course to be fully funded, the retiree health benefit obligation is funded on a pay-as-you-go basis as premiums are paid, rather than on a full accrual basis.[15] Consequently, while the pension benefits being earned now by Postal Service employees are recovered through current postal rates, the retiree health benefits of those same employees are not being recognized in rates until after they retire. This pay-as-you-go approach is also being used to reflect retiree health costs in the Service's financial statements. We believe that it would be preferable for the Service to account for these retiree health costs and related obligation in its financial statements on an accrual basis. As we noted in our September 2002 correspondence to the Postmaster General,[16] the Service's current accounting treatment does not reflect the economic reality of its legal obligation to pay for these costs, and current ratepayers are not paying for the full costs of the services they are receiving. Although the Service did revisit this issue and did discuss it in the management discussion and analysis section of its financial statements for fiscal year 2002, it did not adopt accrual accounting for retiree health benefit costs, or change its financial disclosure treatment as we suggested. Consequently, we continue to believe that the Service's treatment of retiree health benefit costs in its financial statements does not sufficiently recognize the magnitude, importance, or meaning of this obligation to decision makers or stakeholders. In our view, the time has come for the Service to formally reassess how it accounts for and discloses this very significant financial obligation.

Irrespective of the accounting treatment, we believe the Service needs to work with the PRC to determine how best to address this issue in the rate-setting process. We recognize that the adoption of accrual accounting for retiree health obligations and inclusion of the related costs in postal rates could mean that customers face significant rate increases sooner than might otherwise be the case. However, without a change now, a sharp escalation in rates in future years will be necessary to fund these costs on a pay-as-you-go-basis.

[15]The Postal Service paid about $1 billion to OPM in fiscal year 2002 for the cost of retiree health care benefits for its more than 475,000 employees and survivor annuitants who participate in the Federal Employees Health Benefits Program (FEHBP).

[16]See GAO-02-916R.

Effective Labor-Management Relations and Support Systems Are Key to Improving Operational Efficiency

Thus far, I have focused most of my comments on areas that require statutory or regulatory changes. However, one of the most important factors in the Service's future success may not depend solely on actions by the Commission, Congress, or other stakeholders. Rather, it will depend to a large extent on the Service's support systems and its ability to work together with its unions to make the changes needed to improve organizational efficiency and sustain productivity improvements. This may require significant changes in organizational culture and practices, which have historically been difficult to achieve. We have written many reports discussing the long-standing adversarial relationships between postal managers and unions.[17] These adversarial relationships have major financial, operational, and human capital implications because personnel-related costs represent the largest single element of the Service's annual expenses, and they are the primary determinant of prices and the key factor in the Service's overall financial viability. In addition, postal employees represent a valuable asset and are a key element in any overall transformation effort. Disagreements between these groups have included performance management issues, including whether to implement some type of performance-based incentive system for employees covered under collective bargaining, and work rules, such as the deployment and utilization of the workforce. Furthermore, the Service's ability to realign its workforce may be limited because its workforce planning is essentially designed to support short-term operations rather than assess long-term workforce needs, and it may not have sufficient flexibility to make needed changes in its work rules.

Performance Management

We have found that high-performing organizations often must fundamentally change their cultures so that they are more results-oriented, customer-focused, and collaborative in nature.[18] To foster such cultures, these organizations use their performance management systems as a strategic tool to drive change and achieve desired results. The Service will need to modernize its performance management systems to create a clear linkage—"line of sight"—between individual performance and

[17]For example, see U.S. General Accounting Office, *U.S. Postal Service: Labor-Management Problems Persist on the Workroom Floor*, GAO/GGD-94-201A/B (Washington D.C.: Sept. 29, 1994); *U.S. Postal Service: Little Progress Made in Addressing Persistent Labor-Management Problems*, GAO/GGD-98-1 (Washington D.C.: Oct. 1, 1997).

[18]U.S. General Accounting Office, *Results-Oriented Cultures: Creating a Clear Linkage between Individual Performance and Organizational Success*, GAO-03-488 (Washington, D.C.: Mar. 14, 2003).

organizational success. First among the key practices high-performing organizations use to develop effective performance management systems is to align individual performance expectations with organizational goals. Another key practice is to involve employees and stakeholders to gain ownership of the performance management system.

Poor relationships between postal managers and employees have made it difficult to develop and implement changes to the Service's performance management systems. One of the key challenges in developing a more performance-based culture will be for the Service to work in collaboration with its labor unions and management associations to align individual performance with institutional goals and objectives. The Service's bargaining unit employees, who make up approximately 90 percent of its workforce, do not have performance-based compensation systems and have generally opposed them. Another key challenge will be in addressing those areas where the Service believes it needs additional human capital flexibilities to realign its workforce or modify work rules, but has been or could be hampered through current collective bargaining agreements.[19]

Modern, reliable, effective, and as appropriate, validated performance management systems with adequate safeguards, including reasonable transparency and appropriate accountability mechanisms, must serve as the fundamental underpinning of any successful results-oriented pay reform. The Service reported that it implemented a pay-for-performance system for its executives, managers, postmasters, supervisors, and other non-bargaining employees in fiscal year 1995, but that this system was discontinued in fiscal year 2002. Congress and the Postal Service's Office of Inspector General have expressed concerns about certain aspects of this system, such as the payouts made at the same time the Service was incurring huge losses. The Service reported that it implemented a merit-based pay program in 2002 for its executives and officers, under which goals related to the Service's overall performance goals are set for individuals at the beginning of the fiscal year. The Service also reports that it is in the process of extending a merit-based pay system for the remaining non-bargaining employees later this year. Care should be taken in the design of these systems to ensure that they comply with applicable law (e.g., pension cost savings cannot be used for management bonuses)

[19]In broad terms, human capital flexibilities represent the policies and practices that an organization has the authority to implement in managing its workforce to accomplish its mission and achieve its goals.

and that any productivity-based measures result in real savings or more effective utilization of any existing excess capacity.

Addressing challenges in performance management will require the Service's managers and employees to share a common vision for the future and a mutual responsibility for the Service's financial and operating performance. Postal managers and employees will need to balance their individual interests with those of the organization, particularly in the performance management and workforce realignment areas. A common vision and a balanced approach should help achieve and sustain productivity improvements that will be necessary to enhance overall organizational effectiveness and individual performance while appropriately protecting workers' rights.

Workforce Realignment

Another key human capital challenge is to take steps to ensure that an organization has sufficient numbers of people in place with the right skills, tools, and incentives to get the job done. The Service's ability to make changes in the size, cost, and deployment of its workforce has been hampered by some provisions of the collective bargaining agreements. For example, in our reviews, postal plant managers have told us that because of restrictive job classification rules, the Service has too little flexibility to move employees to locations and positions where they are needed. A postal plant manager told us that because of restrictive workforce rules, many supervisors believe it is too arduous to deal with poor performers and that about 60 percent of grievances were work rule based. Changes to the Service's operating environment, such as optimizing its mail-processing network, may require a different mix in the number, skills, and deployment of its employees. These changes may involve repositioning, retraining, outsourcing, and reducing the workforce.

To deal with these challenges, the Service will need effective human capital strategies. It will also need reasonable flexibility to address certain challenges. However, these additional authorities should include appropriate safeguards to prevent abuse of employees. In previous reports and testimonies, we have emphasized that in addressing these human capital challenges, organizations should identify and use the flexibilities already available under existing laws and regulations and then seek additional flexibilities when necessary and based on sound business cases.[20] These additional flexibilities could include (1) more flexible pay approaches, (2) greater flexibility to streamline and improve the hiring process, (3) increased flexibility in addressing employees' poor job performance, (4) additional workforce restructuring options, and (5) expanded flexibility in acquiring and retaining part-time or temporary employees. The tailored use of such flexibilities for acquiring, developing, and retaining talent is an important cornerstone of strategic human capital management so that organizations become more results-oriented, integrated, and customer focused. To address employees' concerns that some flexibilities could be unfairly applied, the Service will need to develop clear and transparent guidelines for using flexibilities, and then hold managers and supervisors accountable for their fair and effective use. By more effectively using flexibilities, the Service would be in a better position to manage its workforce, ensure accountability, and transform its culture to become more results-oriented and efficient.

In closing, this Commission's report will be an important tool to guide comprehensive postal transformation by addressing the major issues related to the legal and regulatory framework of the Service's business model along with various operational and governance issues. As the Commission considers the future direction of the Service, its efforts will involve balancing the Service's future role and mission; governance structure, transparency and accountability mechanisms; and various incentives to increase revenues and control costs. More fundamentally, the Commission's report can provide proposals and mechanisms to help Congress and the President deal with the controversial and long-standing issues that have hampered various postal reform efforts in the past.

For the Service to become a more efficient organization in the 21st century, it will need to

- continue implementation of its Transformation Plan and other Commission recommendations aimed at driving down costs and increasing efficiencies;
- continue enhancements to its financial transparency, including appropriate recognition of its expenses and obligations for retiree health

[20]U.S. General Accounting Office, *Human Capital: Effective Use of Flexibilities Can Assist Agencies in Managing Their Workforces*, GAO-03-2 (Washington, D.C.: Dec. 6, 2002).

benefits as well as disclosure of performance information and transformation progress;

- provide thoughtful consideration of how its pension cost savings can be effectively used after fiscal year 2004 to enhance the long-term viability of the Service;
- develop a comprehensive plan for optimizing its infrastructure and workforce; and
- work with its unions and management associations to create a results-oriented culture, as well as appropriate work rules and realignment flexibilities, that would help achieve both long-term financial viability for the Service and a fair, positive work environment for employees.

Finally, in many ways, the Service's transformation issues are an illustration of the types of challenges that many government agencies face in positioning themselves for the 21st century rather than simply building on past practices. The Postal Service plays an important role for our nation and all Americans. It helps to connect our nation both domestically and internationally. However, the world has changed dramatically since the last postal reorganization in 1970. The Service must change to recognize these realities and position itself for the future. The time for action is now.

Messrs. Chairmen, this concludes my testimony. I would be pleased to answer any questions that you or Members of the Commission may have.

Contacts and Acknowledgments

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Appendix: Analysis of the Postal Service's Civil Service Retirement System Liability

In May 2002, we asked OPM to estimate—as of September 30, 2002—the extent to which the Postal Service had funded and was projected to have funded the CSRS costs of its employees and annuitants for civilian service rendered since July 1, 1971, the effective date of the Postal Reorganization Act. In order to make these determinations, OPM had to first estimate how much of the net assets of the Civil Service Retirement and Disability Fund (CSRDF) were attributable to the Service's CSRS participants. OPM accomplished this task by first constructing a hypothetical "Postal Fund," into which agency and employee contributions were credited and from which benefit payments and a portion of the CSRDF's administrative expenses were charged. It was also necessary for OPM to allocate a portion of the CSRDF's actual investment returns since fiscal year 1972 to the "Postal Fund," even though under what was then current law Treasury bore all investment risk and any resulting gains and losses. OPM also assumed in its initial calculations that the Service was responsible for the applicable military service costs of its employees, which was consistent with the administration's legislative proposal. However, under the then current law, funding of these military costs was the responsibility of the Treasury.

Table 2 shows the current and projected funded status of future CSRS benefits payable to the Service's employees and annuitants calculated to reflect both the administration's proposal that the Service be responsible for military service costs and the then current law, which had Treasury responsible for these costs. The present value of future contributions in table 2 reflects the Postal Service's funding of CSRS benefits as established in the then current law.

Table 2: Funded Status of Postal Service CSRS Benefits Under Pre-P.L. 108-18 Funding Approach

Dollars in billions as of September 30, 2002

	The Service responsible for benefits attributable to military service	The Service not responsible for benefits attributable to military service
Present value of future CSRS benefits	($190.4)	($179.1)
"Postal fund" net assets	168.4	185.0
Current amount of benefits (to be funded) / overfunded	(22.0)	5.9
Present value of future contributions	99.7	99.0
Projected overfunding	$ 77.7	$104.9

Source: Developed by GAO based on OPM data and actuarial calculations.

The extent to which the Service had already funded all future benefits is the difference between the present value of those future benefits and the hypothetical “Postal Fund.” The extent to which the Service is projected to have funded all future benefits is the difference between the current amount to be funded (or the current overfunding) and the present value of all future contributions based on what was then the current law. Calculating the funded status of civilian benefits established a benchmark from which the cost of alternatives to the funding of military service could be calculated.

Table 3 shows the effect on the projected overfunding as a result of changing the approach to funding future CSRS benefits. All present value figures in tables 2 and 3 reflect CSRS-wide demographic assumptions. P.L. 108-18 permits the Postal Service to request that OPM reconsider calculating these present values using Postal Service-specific demographic assumptions. Both tables show that the shift of military service costs from the Treasury to the Postal Service amounts to over $27 billion.

Table 3: Funded Status of Postal Service CSRS Benefits Under P.L. 108-18 Funding Approach

Dollars in billions as of September 30, 2002	The Service responsible for benefits attributable to military service	The Service not responsible for military related benefits
Current amount of benefits (to be funded) / overfunded	($ 22.0)	$ 5.9
Present value of regular agency contributions	11.8	11.8
Present value of employee contributions	4.7	4.7
Present value of future employee military service deposits	0.7	0
Projected (underfunding) / overfunding	($ 4.8)	$ 22.4

Source: Developed by GAO based on OPM data and actuarial calculations.

The administration believed that making the Postal Service responsible for funding military service benefits—both retrospectively to fiscal year 1972 and prospectively from enactment of any legislation—was appropriate in part because its legislative proposal would shift investment risk to the Postal Service. Since fiscal year 1972, the CSRDF earned more than OPM assumed it would. Consequently, while P.L. 108-18 made the Service responsible for funding the cost of military service benefits for all employees hired after June 30, 1971, and a portion of the costs for those employees hired before July 1, 1971, the Service received the benefit of these higher than expected investment returns. Similarly, in the future, investment returns that are above or below expectations will decrease or increase the Postal Service's pension costs, respectively. Furthermore, P.L. 108-18 results in postal ratepayers paying for the cost of military service creditable towards a CSRS benefit the same as they currently do for the Service's employees who participate in the Federal Employees Retirement System.

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