MAY 28, 2003

TESTIMONY BEFORE THE PRESIDENT'S COMMISSION ON THE USPS

JPMorgan

Management is faced with a number of challenges and inflexibilities

Challenges:

- fixed costs, labor costs and ability to cover future obligations,
- declining mail volume growth,
- growing competition from the private sector, electronic diversion, niche markets, new advertising media and international posts

Inflexibilities:

- break-even mandate and limited access to capital,
- universal service mandate and its growing cost,
- inflexible pricing

Overview of the USPS's revenues and expenses

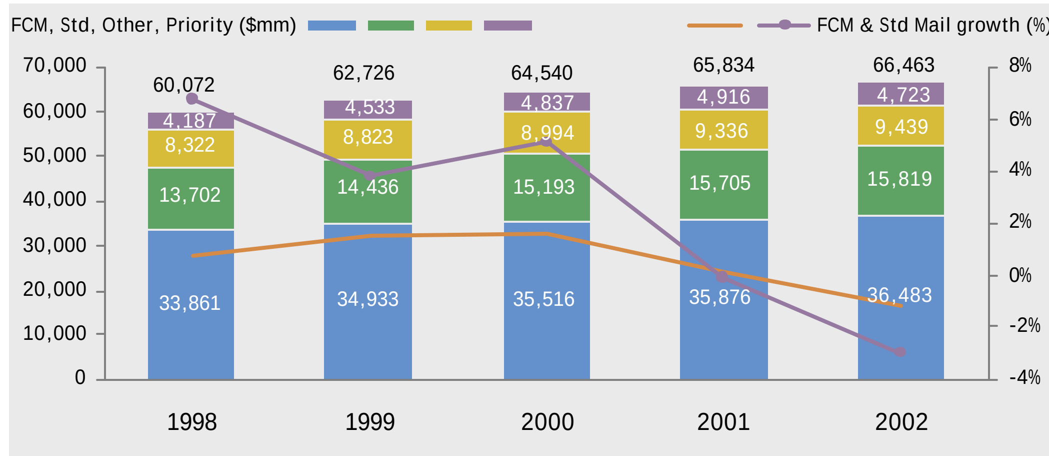
Revenue Overview

- First class mail and advertising mail make up 79% of the USPS's revenue
- Rate changes must be approved by the PRC, which is a lengthy process
- Mail consolidation, electronic diversion and competitive pressures threaten the USPS' core business

Expense Overview

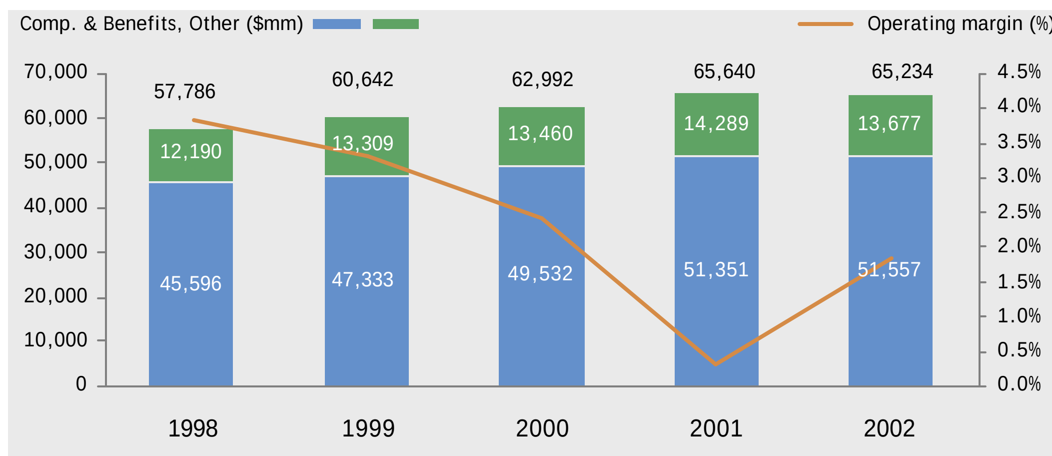
- 79% of expenses are for labor
- The USPS's universal service mandate requires expensive infrastructure expansion as the population grows
- Capital investments may be limited due to restricted debt capacity and a Congressional statute to achieve break-even net income

Revenue composition



Source: Company reports

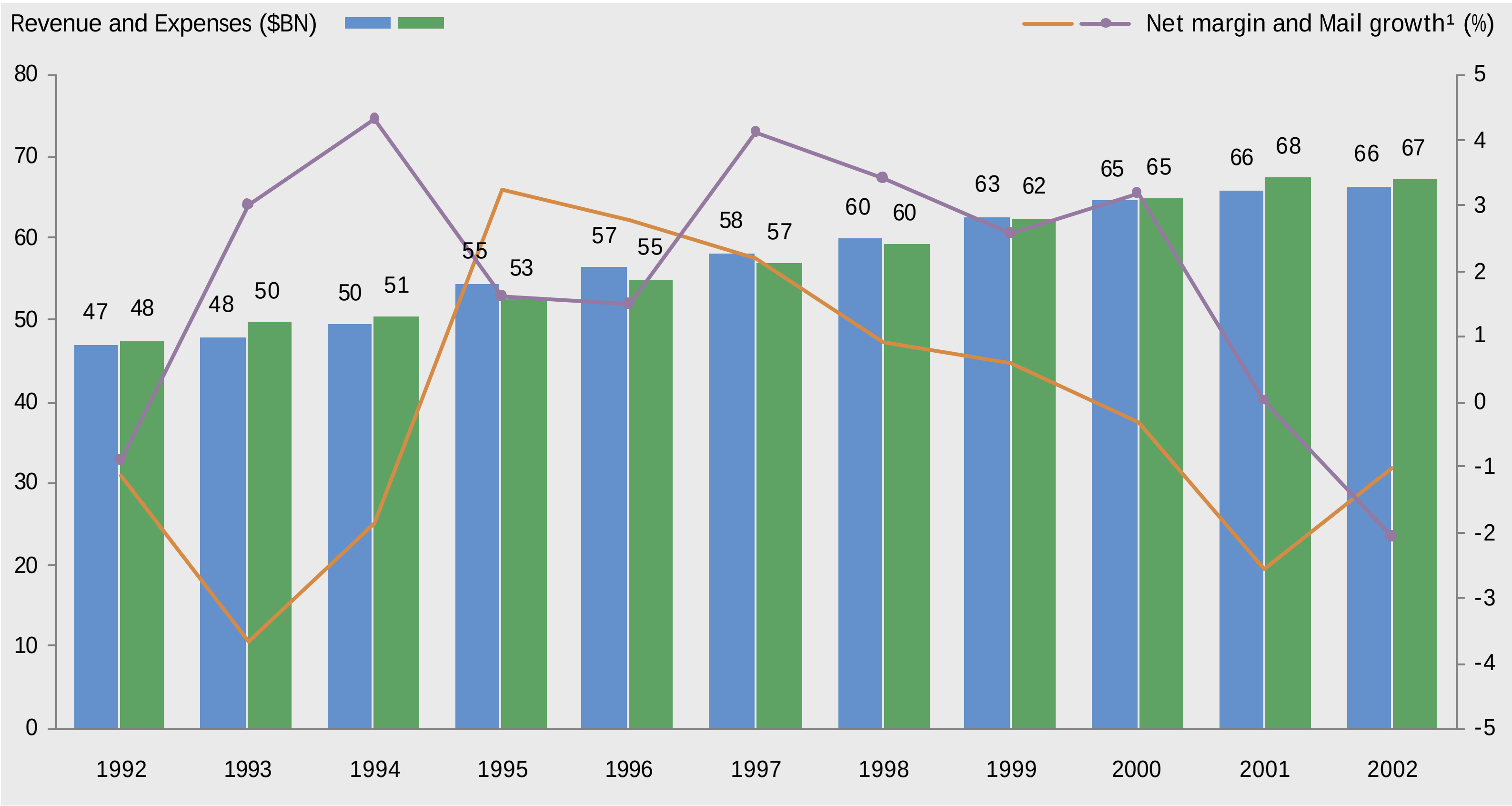
Operating expense composition



Source: Company reports

Continued declining mail volume growth would result in sustained pressure on USPS's thin margins

Financial performance relative to mail volume growth



Source: Company reports
¹ Consists of First-class and Standard Mail pieces

The USPS's investment needs are very large as a result of the universal service mandate

- The USPS' universal service mandate requires uniform, high quality service at flat prices to an ever growing customer base
  The USPS:
  - delivers to over 140MM delivery points per day
  - delivers over 200BN pieces of mail per year
- The USPS needs to invest $600MM every year to accommodate growth in the universal delivery system[1]
  - 1.7MM new address per year
  - over 3,400 new carrier routes per year
  - 100 new delivery facilities per year

[1] 2001 Annual Report and company reports

Compensation and benefits represented 79% of the USPS's $65BN operating expense base in 2002

- The USPS is the second largest employer in the U.S. with 854,376 employees[1] comprising approximately one third of the entire Federal Government civilian workforce
- By 2010, 85% of Postal executives, 74% of Postal managers and supervisors, and 50% of the career workforce will reach retirement eligibility posing significant management challenges and retirement costs[2]
- Management and the unionized workforce are required by law to participate in collective bargaining on wages and working conditions and disputes are settled in binding arbitration if an impasse persists 180 days after negotiations commence

[1] Total career employees - 752,949 (2002 Annual Report)
[2] GAO Report: Major Management Challenges and Program Risks (January 2001)

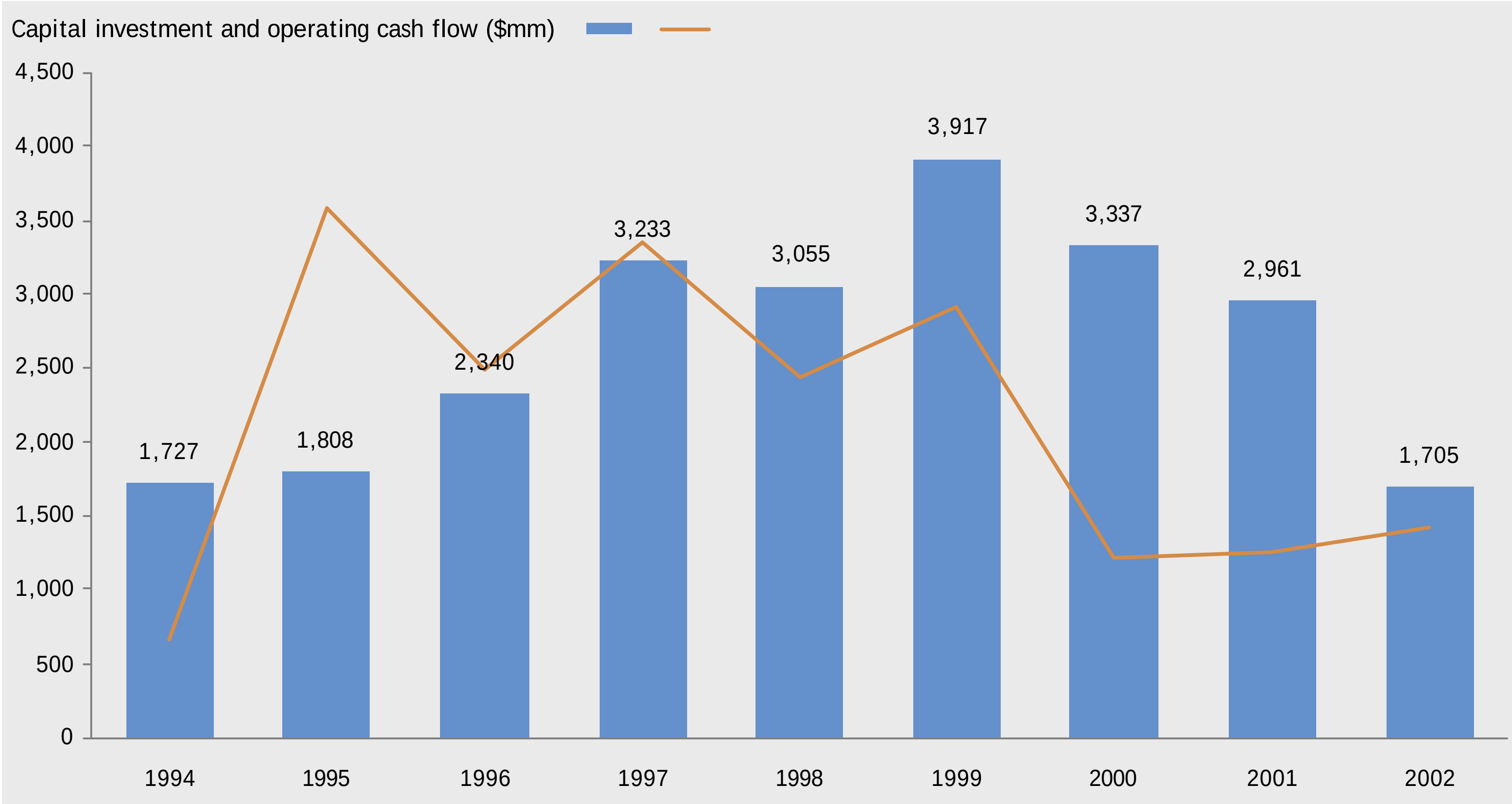
Capital investment management is a necessary challenge

- The USPS relies on two sources of funds for its capital investment needs
  - Internally generated cash flow
  - Debt
- The USPS was originally capitalized with roughly $3BN. This capital has since been depleted by losses and its recovery is factored into the rate setting process. Capitalization now stands at ($3BN)[1]
  - The recovery of prior years' losses is a slow process with little impact on the business model
- Continuing to cover related overhead costs that do not vary with volumes could lead to higher prices if the USPS is to fulfill its mission

[1] 2002 Annual Report

Capital expenditures have historically been funded by operating cash flow and debt

Capital investment vs. operating cash flow



Source: Company reports

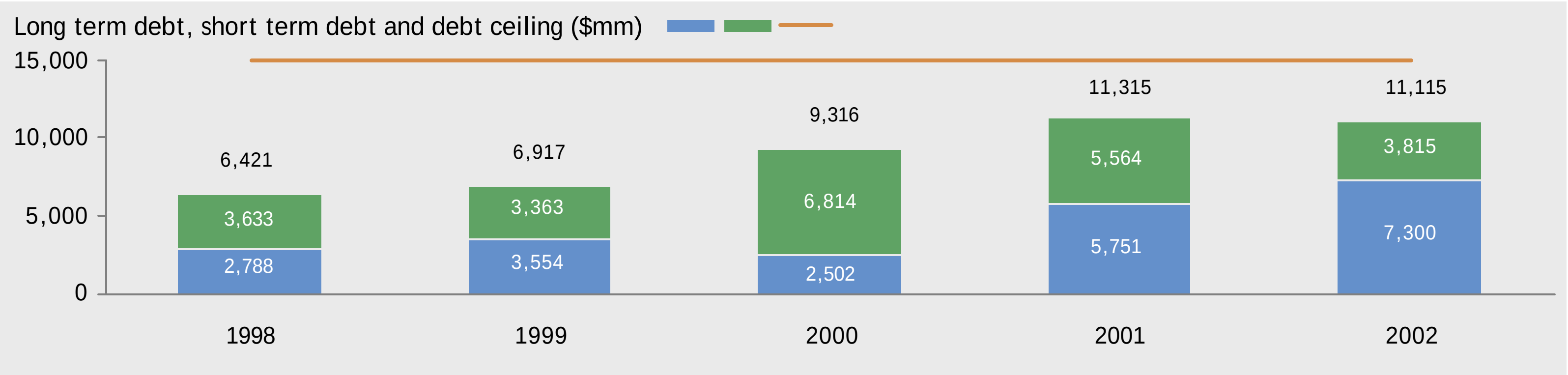
Pricing inflexibility combined with a break-even mandate make revenue management complex

- The USPS is required by law to break-even over time
  - managing to this goal without dynamic pricing and with a rigid cost structure makes meeting this requirement a complex, multi-year task
- To change domestic postage rates, the USPS must file a proposal with the independent Postal Rate Commission (PRC) starting a complex process that results in a “PRC-recommended” decision which must be delivered by law within 10 months
- Efficiencies achieved can only be enjoyed until the next rate case at which time, cost savings are absorbed in a lower rate than would be set had those cost savings never been realized
- The recovery of prior years’ losses to replenish the USPS’s original equity is accounted for in rate case filings. The restoration of original equity means that the USPS cannot retain surplus earnings and put that capital to work
- The impact of the latest rate case will cycle through on June 30th leading to flat or negative revenue growth year over year if volume trends continue

The USPS is restricted in its borrowing capacity and its investment decisions

- Under current law, the USPS can only borrow up to a total of $15BN to fund both operations and capital investments with a limit of $1BN per year to defray operating expenses and $2BN per year for capital improvements
  - the USPS' requirement to break-even over time hinders its ability to generate cash flow that can be used to finance capital investments
  - current limits should be considered in the context of other financial inflexibilities
- The Postal Service's investment authority is limited as well
  - varying interpretations of the law related to investments have restricted the USPS in its ability to effectively partner with private sector companies
  - limits potential for efficient strategic alliances to develop new business opportunities
- Debt limits, a lack of equity and the lengthy rate setting process leave the USPS hard-pressed to defray operating losses in-between rate cycles

Borrowing history



Source: 2002 Annual Report