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The Postal Service Business Model: Broken or Poorly Managed?

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BY

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Executive Summary

To what degree is the Postal Service's business model the source of the Service's present financial problems, as compared to the failure of postal management to manage effectively within the constructs of that model? The dramatic downturn of the Postal Service's fiscal performance in recent years can be traced in large part to two factors: (1) a failure to consistently budget for and capture savings made possible by large capital investments, and (2) a fundamental misunderstanding of postal economics by postal management in relying on economies of scale which do not exist in the provision of postal services.

The Postal Service's execution of its business model, as dictated by the Postal Reorganization Act, has emphasized mail volume growth as its basic strategy. This strategy, coupled with an ongoing failure to create significant increases in productivity, stands in the way of any efforts to improve the Service's financial condition. This analysis includes eight specific policy recommendations for the Presidential Commission on the U.S. Postal Service to consider.

I. Preface

Viewed against a landscape of mounting and persistent billion-dollar deficits, frequent postage rate increases and declining mail volume, the business model of the Postal Service is frequently cited as outdated and overly restrictive. Postmaster General John Potter and his leadership team have expressed repeatedly that the Postal Service is over-regulated and too constrained to control its costs effectively. Because it is prohibited from adjusting to market conditions with flexible pricing and new products on a timely basis, they argue, it cannot keep up with private sector competitors.

The proposition similarly suggested is that unless mail volume rebounds and begins to increase, especially in First-Class Mail, the universal service requirement to serve an ever-expanding number of addresses nationwide on a six-day a week basis will inevitably drive the price of postage to prohibitive levels.

The financial distress of the Postal Service needs to be evaluated in terms of the Service's overall performance since the passage of the Postal Reorganization Act in 1970. This legislation defines the business model presently being questioned. The most relevant issue is: To what degree is the Postal Service's business model the source of the Service's present financial problems, as compared to the failure of postal management to manage effectively within the constructs of that model? Merely changing the rules to grant management more freedom will do little to improve the financial performance of the Postal Service as long as it continues to fail to improve its productivity.

II. Overview

Postal costs were heavily subsidized prior to passage of the Postal Reorganization Act, which transformed the postal system from a department of the executive branch of government, with the Postmaster General appointed by the President, to a quasi-independent legislative entity. The Act essentially removed these subsidies and charged the newly-created Postal Service with operating "like a business" that breaks even financially, while providing universal mail delivery services at economical prices. The constructs of the Act are what define the Postal Service's current business model.

The Act also granted postal labor unions the right to collective bargaining with a binding arbitration provision in the absence of a negotiated settlement. The initial negotiated settlements produced wage increases for postal workers considerably in excess of the inflation rate in the economy; but stabilized thereafter with some arbitration awards considerably below the wage increases of private sector workers.

There were also restraints placed on the Postal Service in terms of its freedom to reduce costs. The Postal Service has over 40,000 post offices, many of which are very small and produce little revenue, but it is specifically prohibited from closing post offices simply on economic grounds. Maintaining this vast array of post offices has become, at least implicitly, a part of the universal service requirement of the Postal Service.

Postal Service overall performance under this business model was reasonably stable through the 1990s. Despite the turbulent economic conditions of the 1970s and early 80s embodying two major recessions, double-digit inflation and a quadrupling of energy prices, by FY 2000 the Postal Service had accumulated a net capital deficiency of only $646 million, and an outstanding debt of $9.3 billion. Postage rate increases, on average, matched inflation in the total economy. USPS productivity increases, averaging 0.4 percent annually, similarly were only slightly less than improvements in the private sector until the late 1990s, when private sector productivity advanced rapidly. Mail volume throughout this period grew at rates at or above the rate of total economic growth, revealing no evidence of disappearing in favor of emerging technologies.

Since FY 2000, however, the Service has accumulated a deficit of $2.6 billion, a net capital deficiency of $3.0 billion, and an outstanding debt of $11.1 billion. Meanwhile First-Class Mail volume has declined by a modest 1.0 percent by year-end FY 2002. What has gone wrong? That is the essential question that must be resolved before meaningful changes can be made to the Postal Service's business model that would seek to ensure a continuation of economical and universal postal services for the future. The terrorist attacks of September 11, 2001, followed by anthrax in the mails and a staggering economy with major business failures, certainly contributed to the Service's difficulties. However, it should be noted that the Postal Service's February 2001 announcement of an expectation of impending multi-billion deficits, after increasing postage rates in January, preceded these tragic events.

III. Postal Service Performance: Economic Trends Belie Management's Faulty Assumptions

The dramatic reversal of the Postal Service's fiscal performance in recent years can be traced in large part to two factors: (1) a fundamental misunderstanding of postal economics by postal management and; (2) a failure to consistently budget for and capture savings made possible by large capital investments. Since its inception, the Postal Service has been managed as if a large share of its costs, between 40-60 percent, are fixed and thus do not grow with the level of the work to be done. The notion is that as mail volume (and hence postal workload) grows, unit costs decline, creating profits for the organization as this increased workload is spread over these large fixed costs. These profits, it is argued, essentially fund the provision of universal service. But this strategy relies on assumptions that are fundamentally incorrect.

The Absence of Economies of Scale

On an intuitive level, the notion of large fixed costs and the potential positive economic benefits from mail volume growth is appealing. The large number of mail processing and distribution plants, postmasters staffing 40,000 post offices and the number of mail delivery routes do not readily expand with the growth of mail volume. In fact, if a simple division of total postal costs, adjusted for inflation, is divided by total mail volume, the computed cost per mail piece declined about 20 percent from 1980, the start of a period of rapid mail volume growth, to the year 2000. Thus it may seem plausible that a strategy to grow mail volume and hence revenue could relieve financial distress and produce a financially viable Postal Service.

But upon further examination, this premise is a misleading and an inappropriate one on which to base postal management strategy. Unfortunately, what positive economic benefits could be derived from mail volume growth are inadequate when matched against the Service's prevailing financial distress. The validity of this fact hinges upon understanding the dynamic between increasing mail volume and postal workload growth. Mail pieces have always differed in their work requirements. A large parcel, for example, requires more work to process and deliver than a one-ounce letter. But with the introduction of worksharing discounts in the late 1970s, the growth of mail volume became an increasingly misleading barometer of postal workload growth. Presorted mail pieces that receive these discounts produce less revenue per piece and require less postal work to deliver, have become an increasing share of total mail volume.

By the mid 1980s, about 30 percent of First-Class Mail was presorted to at least the 5-digit zip code level and about 60 percent of Standard Mail (advertising mail) was presorted to carrier route. When postal workload, which includes growth in delivery stops, and all other postal work is calibrated for the differing work content of the different mail pieces, postal workload has grown far less rapidly than mail volume. From 1980 to 2000, mail volume grew 67 percent while postal workload grew only 41 percent. In fact, postal workload has grown only slightly faster than total, inflation adjusted postal costs; leaving unit workload cost essentially unchanged.[1]

[1] Dianna C. Christensen, Laurits R. Christensen, Charles E. Guy and Donald J. O'Hara, "U.S. Postal Service Productivity: Measurement and Performance", Regulation and the Nature of Postal and Delivery Services, Edited by Michael A. Crew & Paul R. Kleindorfer, Kluwer Academic Publishers, Boston, Ma. 1993, pp. 237-260.

For postal policymakers the fact that unit postal costs do not decline as postal workload increases means that no profits accrue to the Postal Service due to simply increasing mail volume or, more precisely, postal workload. *In more technical terms, there are no economies of scale in the provision of postal services.*

This conclusion might appear counterintuitive, and in conflict with conventional wisdom on the subject. Such apparent conflict is due to a tendency to confuse the economies to be gained from delivering more mail over a fixed delivery network with the cost consequences of increasing the size of the entire postal system. There is, in fact, a positive financial benefit from delivering more mail over a fixed delivery network. In particular, a 1.0 percent increase in mail volume-related workload causes costs to increase only 0.8 percent as this mail is absorbed over the fixed delivery network. In turn, an increase of 1.0 percent in delivery stops, as is typical annually, only causes costs to increase 0.2 percent. But, a 1.0 percent increase in both mail volume workload and delivery stops will result in a 1.0 percent increase in total postal costs as well.

Thus, there is no positive financial benefit to be gained simply from increases in the size of the total postal system. Without explicit management actions to reduce costs, an increase in total postal workload will cause total costs to increase in like proportion. Consequently, granting the Postal Service pricing flexibility to offer more discounts to spur mail volume growth cannot, unaccompanied by other cost-cutting management actions, relieve the financial distress of the Postal Service. In fact this pricing strategy could worsen the Service's financial condition if the requisite costs savings made possible by these discounted mails are not captured.

Failure to Increase Productivity

Notwithstanding the absence of economies of scale, the Postal Service's execution of its mandate under the provisions of the Postal Reorganization Act, and hence its current business model, has emphasized mail volume growth as its basic strategy. In fact, two potentially conflicting business strategies have been pursued. On the one hand, the Service has engaged in a massive investment in automated mail sorting equipment, while on the other hand, it has increasingly offered mailers discounts to sort their mail before submitting it to the Postal Service for distribution to final delivery. The worksharing discount policy of the USPS has been very successful in terms of stimulating increased mail volume, especially advertising mail. Some argue that the Service's worksharing pricing strategy served to create the direct mail advertising industry. However, since these workshared mails produce less revenue per piece and contain little postal workload, the financial consequences for the Postal Service have been less rewarding.

It would be fair to conclude that, to the extent that work-share discounts served to constrain the growth of the Postal Service's facilities and 900,000 person workforce, they have served at least a somewhat beneficial purpose. However, the productivity improvements made possible by large investments in mail automation equipment have not been forthcoming. Opportunities to reduce labor costs as the faster automated mail sorting equipment replaced the slower and more labor-intensive mechanical letter sorting machines, for example, were largely missed. These displaced workhours were in large part simply utilized elsewhere. Consequently, Postal Service productivity increased by only 5.7 percent between the start of the automation investment program in 1985 and 2000. In fact, this modest productivity increase, amounting to only 0.3 percent per year, means that these investments have produced no increase in the Service's long-term productivity trend.

The substantial productivity increases in FY 2001-02 and so far in FY 2003 are long overdue. Whether these new productivity increases can be maintained into the future, though, is extremely uncertain based on the Service's failure to maintain similar increases in the past.

It is also important to note that the Service operated with a positive net income for five consecutive years, from 1994 to 1999. However, productivity declined substantially in all but one of these years, even though mail volume grew 11 percent. These productivity losses make clear positive economies of scale were not the source of the positive financial results. The true source was a beneficial labor arbitration award in 1995, wherein; the growth of the wages of the Postal Service workforce were restrained by two percent points per year relative to those of the private sector for a four-year period.

Implications for the Postal Service Business Model

During this period of financial health, the Postal Service also expanded its pricing strategy to increase mail volume by offering more discounts to mailers who took steps to make their mail easier for the Service's automated mail processing equipment to process. This strategy was again very successful in terms of increasing the flow of mail across the automated equipment. Automation-compatible mail has grown nearly 6.0 percent per year. However, as in the case of presorted mails, revenue per piece for automation mail is much smaller, rendering the financial consequences of this strategy much less successful. In fact, the Postal Service frequently reported difficulty capturing savings made possible by these mails since its growth was greater than expected.

To further spur mail volume growth, when postage rates were increased in January 1999 and again in January 2001, both increases were within the average rate of inflation in the economy. But each rate increase failed to generate revenue sufficient to sustain the financial health of the Postal Service. The cost base for the 1999 rate increase, as filed with the Postal Rate Commission, contained only a 1.0 percent provision for contingency -- the smallest such provision of any prior rate filing -- thus reducing the requested revenue by more than $1 billion. The expected workhour savings filed with the Rate Commission in support of the 2001 postage rate increase was substantially greater than the USPS actually included in their operating budget, thus again, the Service understated their revenue needs in this rate filing. This is indicative of a business strategy based on generating additional revenue through greater mail volume as a consequence of selectively lowering postage rate increases.

For the reasons previously stated, this strategy cannot succeed in the absence of economies of scale, and no such economies exists for the Postal Service. As a result, the Service's business strategy, coupled with a failure to create significant increases in productivity, can be seen to have laid the foundation for the February 2001 Board of Governors' announcement of impending financial doom for the Postal Service.

The decline in First-Class Mail by 0.1 percent in FY 2001 and 1.2 percent in FY 2002 respectively, and by 2.7 percent in the first quarter of FY 2003 has led many to speculate that the longanticipated diversion of hard copy mail to emerging electronic forms has finally started. Total mail volume declined in both years, but then returned to increase 1.5 percent in the first quarter of FY 2003, led by a rebound in advertising mail. Should First-Class Mail continue to decline, this presents a major long-term problem for the Postal Service, whose hard-copy mail delivery network continues to expand with rising numbers of households and businesses. In particular, should the non-discounted portion of First-Class Mail continue its decline, solvency will depend on finding alternative means to fund the delivery costs of the present universal requirements.

With the many disruptions since the fall of 2001, combined with the frequent postage increases of the last six years, it is premature to conclude that growth of First-Class Mail will not resume once economic and postage rate stability returns. There is no evidence available to confirm that transactions typically conducted through the mails in the past are now being replaced by online activity to any reasonable order of magnitude. While a host of evidence exists that a vast volume of activity, such as email and online purchasing, is occurring electronically. Whether these activities create more or less mail remains to be proven. Further, Postal Service costs do not increase in direct proportion to increases in the growth of mail delivery stops. As noted earlier, a 1.0 percent growth in delivery stops increases postal costs by only 0.2 percent.

IV. Summary and Conclusions

The performance of the Postal Service during the first decade or so following passage of the Postal Reorganization Act may be viewed as quite successful when judged against the modest yardstick of the law's provisions. After smoothing the rough edges of the price-making format and the initial efforts to revise the working conditions and pay level of its labor force, USPS performance essentially matched that of the economy. In the absence of any more specific requirements, matching the average performance of the economy became the generally accepted yardstick for Postal Service performance. Initially this accomplishment was relatively easy to achieve given the poor performance of the prior Post Office Department and the very sluggish performance of the economy. The economy was experiencing double-digit inflation and stagnant productivity gains. However, as the economy's productivity performance improved and inflation returned to a more modest level matching this performance became more difficult.

The Postal Service's twofold response to this challenge -- offering discounts to mailers for presorting their mail and making large investments in automated mail processing equipment -- contributed significantly to its current financial distress. While mail volume did increase, the investment in automated equipment produced very little productivity improvement in the total postal system. The automated equipment may work as planned in terms of mail processing, but the saving made possible have not been captured on the bottom line.

These Postal Management actions during the 1990s to accelerate revenue through mail volume growth, while restraining the average increase in postage rates without complementary efforts to improve productivity, have necessitated frequent postage increases over the last six years. This business strategy coupled with the tragic events of September 11, 2001 and their aftermath, combined with the recent recession in the U.S. economy, has culminated in serious financial distress for the Postal Service.

The General Accounting Office has identified the financial operations facing the Postal Service and subsequently placed the Service's long-range outlook on its high-risk list. In a January 2003 update of its 2001 Performance and Accountability report, GAO concludes, "The Service has made some improvements in its financial information since 2001, however, we continue to have concerns about the transparency of its financial and performance information." These concerns should also be a major reform focus for the Presidential Commission.

The Postal Reorganization Act clearly is inadequate to guide the Postal Service into the future. It contains far too little in terms of goals and objective performance expectations for the Postal Service. The Act merely instructs the Postal Service to perform in a businesslike manner and become efficient and serve the public good. However, the Postal Service in its execution of the tenets of this legislation has contributed significantly to the problems it now faces. Changes need to be made which will better instruct the Postal Service in terms of its expected performance and to compel management to meet these expectations.

V. Recommended Changes to the Postal Reorganization Act

1. The financial break-even provision should be replaced with an allowance for capped profit and retained earning. The cap should be in the range of 6-8 percent of the Postal Service's total capital stock, following a thorough evaluation of its worth.

2. Provision should be made for the Postal Service to provide publicly a detailed five-year business plan including expected productivity gains and postage price changes. Any suggested new product offering must be justified by a detailed performance plan including its expected impact on profitability. The Postal Service should be required to provide public quarterly reports on its achievements with respect to this business plan.

3. A profit sharing plan, based on profits devoid of postage rate change, should be devised to provide management incentive to achieve its business plan.

4. Limit the business activities of the Postal Service to its core mission of providing hard copy mail service for traditional letters and periodicals.

5. Provision should be made for the Postal Service to consolidate or close postal facilities as needed to control costs and improve efficiency.

6. Provision should be made for the Postal Service to use centralized delivery schemes and other such efficiency-enhancing methods of mail delivery.

7. The authority to determine the extent of the postal monopoly, including the USPS's exclusive access to the mailbox, should be placed in a joint committee comprising both the Postal Service Board of Governors and the Postal Rate Commission. The monopoly definition and access privileges should be reviewed annually to determine necessary changes.

8. The Postal Rate Commission should be granted subpoena power.

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