S. Hrg. 109–198

U.S. POSTAL SERVICE: WHAT IS NEEDED TO ENSURE ITS FUTURE VIABILITY?

HEARING

BEFORE THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

APRIL 14, 2005

Printed for the use of the
Committee on Homeland Security and Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE

21–430 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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U.S. POSTAL SERVICE: WHAT IS NEEDED TO ENSURE ITS FUTURE VIABILITY?

THURSDAY, APRIL 14, 2005

U.S. SENATE,
COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 2:06 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Susan M. Collins, Chairman of the Committee, presiding.

Present: Senators Collins, Lieberman, Stevens, Coburn, Warner, Akaka, and Carper.

OPENING STATEMENT OF CHAIRMAN COLLINS

Chairman COLLINS. The Committee will come to order.

Today, the Committee holds its ninth and final hearing, I hope, on Postal reform. The time and effort this Committee has devoted to this subject reflect its importance.

The U.S. Postal Service is the linchpin of a $900 billion mailing industry that employs more than 9 million Americans in fields as diverse as direct mailing, printing, catalog production, paper manufacturing, and financial services. A healthy Postal Service is indispensable to thousands of businesses throughout the country. During this series of hearings, we have heard from many such businesses. Whether it is *Time Magazine* or a small community newspaper, affordable universal service is essential to a well-informed public. Whether it is a national retail giant or a small Maine manufacturer of down comforters, a vast sector of our economy depends on the Postal Service.

Yet the Postal Service's future is not assured. At our first hearing in September 2003, the Committee heard from Jim Johnson, Co-Chairman of the Presidential Commission on the Postal Service, who emphasized that the Postal Service was an institution in serious jeopardy. Mr. Johnson went further by warning that, "An incremental approach to Postal Service reform will yield too little, too late, given the enterprise's bleak fiscal outlook, the depth of current debt and unfunded obligations, the downward trend in First-Class Mail volumes, and the limited potential of its legacy Postal network that was built for a bygone era." That was a very strong statement, and it is one that challenges the Postal Service and Congress to embrace far-reaching reforms.

The financial and operational problems confronting the Postal Service are serious, indeed. The Postal Service's long-term liabilities are enormous, to the tune of $7.6 billion for workers' compensation claims, $3.5 billion for retirement costs, and $50 to $60 billion to cover retiree health care costs. The Postal Service also has yet to pay almost $2 billion in outstanding debt to the U.S. Treasury.

There has been some positive news. The Postal Service has worked hard to improve its finances, and in an unexpected turn of events in late 2002, the Office of Personnel Management discovered that if the Postal Service's payments into the Civil Service Retirement System fund were to continue on the basis required under the then law, the Postal Service would overfund its estimated retirement liability by approximately $71 billion over a period of 60 years. Senator Carper and I introduced legislation to correct that funding problem. That bill's enactment enabled the Postal Service to delay its next rate increase and to more aggressively pay down the debt owed to the Treasury.

Despite this reprieve, the underlying problems remain. One of the greatest challenges for the Postal Service is the decrease in mail volume as key components of business communication, such as bills and payments, move increasingly to the Internet. This is highly significant, given that First-Class Mail accounts for 48 percent of total mail volume and the revenue it generates pays for more than two-thirds of the Postal Service's institutional costs.

Two weeks ago, Senator Carper and I reintroduced Postal reform legislation, S. 662, the Postal Accountability and Enhancement Act of 2005. Our legislation preserves the basic features of universal service—affordable rates, frequent delivery, and convenient community access to retail Postal services. As a Senator representing a large rural State, I want to ensure that my constituents, whether they are living in the Northern woods of Maine or out on the islands or in the many rural communities in my State, have the same access to Postal services as the people of our large cities. If the Postal Service were to no longer provide universal service and deliver mail to every customer, the affordable communications link upon which many Americans rely surely would be jeopardized.

Affordable, predictable Postal rates are also of paramount importance to thousands of businesses that rely on the mail and to their millions of employees and customers. This basic fact was brought into sharp focus at a hearing that I chaired in March 2004 in which we heard from several such businesses. One of our witnesses was Chris Bradley, the owner of that small Maine manufacturer of down comforters and pillows. It is called Cuddle Down. The previous rate increase in June 2002 raised standard Postal rates an average of 8 percent. Mr. Bradley pointed out that for Cuddle Down, that meant an increased postage bill of $240,000. He explained that was the equivalent of eight good jobs that would have to be cut just to stay even.

Excessive and unpredictable rate increases clearly are a recipe for business failures and job losses. High rates also further reduce mail volume, aggravate the threat to universal service, and lead to even more rate increases. The only way to avoid what the Government Accountability Office refers to as a potential death spiral is through comprehensive reform, such as the bill we are considering today.

We are working closely with the Administration to implement the recommendations of the Postal Commission appointed by President Bush. I believe those recommendations would put the Postal Service on the path toward financial solvency and prepare it for the challenges of the 21st Century.

The Administration has, however, serious reservations about two significant Commission recommendations. The first is the question of how so-called savings that resulted from our work to correct the Civil Service Retirement System overpayments should be spent. The Administration proposes that the entire $43 billion in savings over the next 10 years be used to prefund retiree health benefits. This would take all of the benefits from correcting the overpayment away from the American mailing public and would lead to unnecessarily high rate increases. This really would amount to a tax on Postal customers.

The second concern that the Administration has concerns who should bear the responsibility for paying the cost of retirement benefits for Postal Service employees that is attributable not to their time working for the Postal Service, but rather their previous military service. The Administration contends that the Postal Service must continue to pay these benefits. I believe that is unreasonable and unfair. It makes no sense to me that we are asking the Postal Service to pay the retirement costs for the military service of its employees. As the President's own Commission noted, this provision, "asks those who use the Postal Service to subsidize the military every time they use the mail." And I would note that the Postal Service is the only entity that is asked to make retroactive payments for this cost.

During this Committee's examination of the issues surrounding Postal reform, which has now spanned some 18 months, we have heard from a wide range of experts. Some have been experts in issues pertaining to government finance and management. Others have been experts in running a business or in keeping the American people informed and in touch with each other. Their perspectives have differed, but their basic premise has not. They all told us that universal, affordable, and predictable Postal rates are a fundamental building block of our economy, and that is why I have spent so much time in my opening statement today making the point that the Postal Service is critical to the prosperity of our economy and it is the source, indirectly, of more than 9 million jobs. It is so fundamental. It is such a part of the fabric of American life that it can easily be taken for granted.

As Benjamin Franklin, the founder of the very first U.S. Post Office, once said, "When the well is dry, we know the worth of water." We must not allow this well to run dry, for we already know that we would lose something very precious.

Senator Lieberman.

OPENING STATEMENT OF SENATOR LIEBERMAN

Senator LIEBERMAN. Thank you very much, Madam Chairman, for that excellent opening statement. I don't know that I could add anything to it, so I won't try to. I will ask that my statement be included in the record.

There are two things, maybe two or three, that I would say. One is that I am going to sometime later today figure out how to order something from a company called Cuddle Down. [Laughter.]

It has already improved the course of my day, just hearing that term mentioned here.

But second, is to thank you and Senator Carper, who I believe is on his way here today, for the extraordinary work you have put into this challenge of Postal reform. The Post Office means a lot to the American people. It is part of our history. It was one of the initial powers given to Congress in the Constitution, and it is facing challenges that obviously the Framers and Founding Fathers never envisioned. But we need it, and we need to do some things to keep its service universal and affordable.

Because the Postal Service is such an important entity to the American people, there are a great diversity of groups and interests involved. There are many who would have said bringing those together, all those groups together to achieve a national purpose in Postal reform, was just about impossible. But you and Senator Carper have done it.

Somebody, I think, described you the other day in this regard as having the wisdom of Solomon. I thought that was a bit gender biased. I wanted to say you had the wisdom of the Prophetess Deborah, and maybe Carper has a little of Solomon in him.

The other thing I want to say to everybody here is what we all know, which is we have got to get together and do this this year or there is going to be a rate increase that will have very harmful effects on our economy. This is a delicately balanced proposal that Senator Collins and Senator Carper have put before us. To my way of thinking, not that anything is perfect, none of us are perfect, no product we come forth with is perfect, but the burden of proof ought to be on anyone making substantial changes to this proposal. What we really need is to get together and figure out how to get it done, not for any special interest, but really for the national interest.

With that, and the hope that Senator Carper is on the way, I thank you very much, Madam Chairman. Look at that. Right on cue.

[The prepared statement of Senator Lieberman follows:]

PREPARED STATEMENT OF SENATOR LIEBERMAN

Madam Chairman, thank you for convening this hearing and for crafting the reform legislation we will discuss today,and more generally, for your faithful commitment to guiding the postal service toward a more solvent future. You and Senator Carper have shown great determination in trying to repair the financial condition of the U.S. Postal Service, and all of America is indebted to you for your hard work.

The Postal Service is one of our nation's oldest public functions. In fact, Section 8, of the United States Constitution gave Congress the power to establish post offices BEFORE it granted the authority to create a judicial system, declare war, or raise an army. The founding fathers recognized the importance of connecting a diverse and dispersed people through long distance communication, and 230 years later, the Postal Service remains essential to our economy and way of life.

In the past year, mail carriers delivered over 200 *billion* pieces to 142 million homes, offices, and other delivery points. More than 707,000 career employees work directly for the Postal Service, and it sustains a $900 billion mailing industry. In short, nearly every American depends upon it.

The existing legislative charter for the Postal Service, the Postal Reorganization Act of 1970, has served us well for many years. But technological and other advances over the last few decades have altered the business model of most American companies, and while the Postal service has worked hard to keep up, there is only so much it can do. Now, it needs our help.

E-mails, faxes, the web, and inexpensive long-distance telephone services have become increasingly popular substitutes for conventional mail. Even in the more traditional markets of overnight express and package delivery, intense competition has rendered the USPS a secondary player in most parts of the country.

The Postal Service is unable to challenge this formidable competition, effectively partly because it operates under a cumbersome system that prevents quick rate adjustment to meet the changing needs of customers and the changing strategies of competitors. To make matters worse, use of the mails to deliver bio-terror agents B anthrax in 2001 and ricin in 2003 B has imposed significant, unexpected costs on the Service.

On top of these challenges is the impending burden of large financial liabilities and obligations, including pension and retiree health obligations. The Postal Service's pension obligations were addressed temporarily in 2003 after we discovered the USPS was substantially overpaying its pension obligations and, without legislation, would have overpaid the U.S. Treasury by over $70 billion.

The Postal Civil Service Retirement System Funding Reform Act, authored by the Chairman and Senator Carper, fixed the situation temporarily by allowing the Postal Service to use those savings for mail delivery through 2005 and avoiding a rate increase.Next year, however, it must begin paying the Treasury again, this time into an escrow account, until Congress decides how the money should be used.

Already, the Postal Service Board of Governors is seeking a rate increase for next year to meet the $3.1 billion escrow requirement. That increase could bump postal rates up by approximately 5.4 percent.

The fear is that we are approaching what those in the postal community call the "economic death spiral," which occurs when falling mail volume and unreasonable financial obligations force postal rate increases that lead to further drops in volume. The way out of the death spiral is through focused leadership. And Chairman Collins and Senator Carper have provided that in the form of S. 662.

Your bill provides a sound framework for reform. It would hold down rates by eliminating the escrow requirement and allowing the Postal Service to use much of the savings for delivering the mail. The bill would also return to the Treasury the obligation to pay for postal worker's retirement costs related to their military service. Other provisions would establish a more flexible and streamlined process for setting postal rates, and help establish a viable business model.

Not all issues have been resolved, but this hearing is an opportunity to hear from knowledgeable witnesses who can help us understand and address those that remain outstanding. Thank you for participating, and I look forward to your testimony.

Chairman COLLINS. Thank you.

You can tell him that he is as wise as Solomon. He would have liked that.

Senator Coburn.

OPENING STATEMENT OF SENATOR COBURN

Senator COBURN. Madam Chairman, thank you for your work, and Senator Carper, for your work, as well, on this. I am new to the Senate, just getting a good look at this bill, and I understand the requirements and the necessity of it happening.

I think there are a couple of important points as I have gone through the testimony that need to be emphasized, and I know your bill goes toward that direction. Incentivization for efficiency is one of the things that has to happen at the USPS. We have got to reward people who save money, who come up with ideas to make the system more efficient. And I hope incentives can be expanded and made more an important part of the system because I believe people respond to that.

And the second thing I would say is you mentioned the significant costs of health care. There isn't a hearing I go to that health care isn't involved, and it is out of control in this country. If we want to save some of this $50 billion, which we know 30 percent of all the health care costs in this country today don't help anybody get well, we need to all be concerned about overall health care reform in this country. I think every bill that we see has health care impact.

The U.S. Postal Service is adversely impacted because of the inflation and lack of efficiency in health care, and we ought to consider even putting a demonstration project in this bill for Postal workers to cut the cost of health care, because it is out there. And where there are projects going, we are cutting the cost of health care 30 percent over the year before.

So it is a big factor. It is a big benefit. It is something that people deserve. By not only cutting the cost, but improving the outcomes, we are seeing that it is possible, and I hope that you will consider that as we move forward on this.

I congratulate you on the hard work that you have done. I look forward to hearing part of the testimony. I have to go to a Judiciary Committee hearing. I won't be able to hear all of it, but I assure you I will have read it and then will work with you to try to bring this to fruition. Thank you.

Chairman COLLINS. Thank you. Senator Akaka.

OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you, Madam Chairman. I am pleased to be here this afternoon to discuss with our distinguished witnesses S. 662, the Postal Accountability and Enhancement Act. I welcome our panelists and thank them for their input into this important discussion.

I also want to take the time, Madam Chairman, to compliment you and Senator Carper. I want to thank you for your steadfast dedication in crafting bipartisan legislation to ensure the future viability of the U.S. Postal Service.

I had the privilege of serving as the Ranking Member alongside Chairman Collins throughout this Committee's series of hearings on Postal reform last year. It was my hope, and I am sure it was the Chairman's hope, too, that the bill introduced in the 108th Congress would have been considered by the Senate prior to adjournment. Although that was not the case, discussions have continued, and I thank all participants for their efforts in turning the challenges faced by the Postal Service into what I consider to be new opportunities.

One area of particular interest to me is financial transparency. I have long advocated the need for greater financial transparency within the Postal Service. In fact, it was the lack of financial transparency that moved the leadership of our Committee several years ago to ask the Postal Service for a comprehensive transformation plan to address its short- and long-term operational and financial goals. I would like to add that Postmaster General Potter ably presented that report to the former Postal Subcommittee in May 2003. Therefore, it should come as no surprise that I support the provisions of the Collins-Carper bill dealing with financial transparency.

There are a couple of major provisions of Postal reform, however, in which differences remain. One issue is military retirement costs, which I know our first two witnesses will discuss. Like the Chairman of this Committee, I do not believe it is fair that the Postal Service should be the only Federal agency to pay retroactive costs.

Another issue is the escrow fund. While all parties support additional flexibility for the Postal Service, the Administration would mandate that escrow funds be used solely to fund post-retirement liabilities. Money used to pay down the long-term liabilities is money unavailable to cover the other costs. That is why I support the provisions in S. 662, which would use the escrow fund to prepay Postal retirement health care costs, to pay down any outstanding debt, and to hold down operating expenses, all of which affect Postal rates.

Chairman Collins, I regret that I am unable to stay for the entire hearing, but I want you to know how much I appreciate what you and Senator Carper are doing on this issue, and I look forward to working with you to ensure that the Postal Service is able to maximize performance, maintain financial viability, and adapt to its competition. Thank you very much.

Chairman COLLINS. Thank you very much, Senator. You contributed greatly to the bill last year, and we look forward to continuing to work with you.

Senator Warner.

OPENING STATEMENT OF SENATOR WARNER

Senator WARNER. Madam Chairman, I won't make an opening statement. I just associate myself with the remarks of my friend and colleague from Hawaii.

My first Federal job was in 1943 as a 16-year-old mail carrier because there was nobody else around during World War II to carry mail. So I have always had a great respect and affinity for the Postal Service, and I am going to be counted on as a supporter. Thank you very much.

Chairman COLLINS. Thank you. I knew a lot of your distinguished past, but I didn't know that it included being a letter carrier, as well.

Senator WARNER. That is right.

Chairman COLLINS. That is wonderful.

Senator WARNER. Thank you. And I got bitten by a dog once, too. [Laughter.]

Chairman COLLINS. I have a feeling that there are a lot of letter carriers out there who could relate to that experience, unfortunately.

I am now very pleased to call upon Senator Carper, who is the primary co-author of this bill.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. Thank you, Madam Chairman. I have said this many times publicly and privately. It has just been a joy working with you and your staff on this effort.

To Senator Akaka, we wouldn't be this far along without your help and support and that of your staff, and we are grateful for that. Thank you for your kind words.

I thought we actually had an excellent chance last year to enact meaningful Postal reform legislation for the first time in, I guess, more than three decades. Madam Chairman, you and I worked with all of our colleagues on this Committee and some that aren't to draft a bipartisan bill that enjoyed the support of a wide variety of interests, from labor unions on the one hand, to the largest mailers, to the Postal Service's private sector competitors. And I wasn't sure I would ever be able to say that last part of that last sentence.

That bill that we introduced and worked through ultimately passed this Committee on a 17–0 vote, and its House counterpart also passed through the Committee over there unanimously. We all know we were unable to get a debate on the floor of the House or the Senate on Postal reform legislation. It continues to amaze me. The bill is reported out of the Committee after years of back and forth. It had unanimous consent in both of the relevant committees. It couldn't get onto the floor for debate.

But I am confident that this will be the year when we get something done. Given all the time, energy, and effort that has been put into it, we ought to.

We once again have a bipartisan bill that enjoys wide support. Also, just yesterday, I think our colleagues in the House, and you probably already said this, but our colleagues in the House were again able to get their version of our bill through the Government Reform Committee, again unanimously, on a 39–0 vote. I believe our bill this year is even better because I think we benefited from the active engagement of a number of folks, including some people in the Bush Administration.

I have been critical, as you know, of the Administration's views on Postal reform—some of the Administration's views on Postal reform in the past. Let me say, the Commission appointed by the President, which actually agrees with us on military pensions, which agrees with us on the escrow account issues—they don't agree with the guy who appointed them, but the Commission agrees certainly with us on those issues. But while we still have some disagreements with the Administration, I think we have narrowed those, and I am pleased we have been able to work with them in recent weeks to include in our bill a number of the President's priorities in areas like financial transparency and executive pay and the rate cap itself.

It is my hope that we can continue to work with the Administration in the coming weeks to come up with an agreement on what I believe are the final issues we don't see eye-to-eye on, Madam Chairman. It is too bad Senator Warner has left, because in addition to carrying mail at the age of 16, he was Secretary of the Navy. He also served in the Navy and in the Marine Corps. I served in the Navy, too. He was my Secretary of the Navy when I was on active duty during the Vietnam War. I still call him Mr. Secretary, and he calls me Ensign Carper. [Laughter.]

No. In all honesty, he calls me Lieutenant Carper.

How can we say with a straight face, or how anyone can say with a straight face, that somebody who has served in the Army, Navy, Air Force, and Marines, have accrued that time in service to our country, and they go to work for a Federal agency, the Treasury Department covers the time for pension purposes, the time that they served on active duty. Yet if they go to work for the Postal Service, that same person, we expect the ratepayer to pay for the military portion of their service. That is just wrong, and it is wrongheaded, as well, and we have got to fix that.

As my colleagues, certainly you, Madam Chairman, are aware, the Postal Board of Governors just last month sent a formal request to the Postal Rate Commission to raise Postal rates by some 5.5 percent next year. This would be an increase of about two cents on a first-class stamp. It would also be the first rate increase since 2002, when we took action to prevent what could have been, I think, a devastating rate increase by reducing the Postal Service's annual pension payment. Let me just say that again—annual pension overpayment, because they were overpaying what they owed for pension purposes.

I am told that this new rate increase of 5.5 percent likely wouldn't be necessary if the Postal Service were not required to begin depositing its pension savings in escrow beginning next year. And while this new request is smaller than some of us expected, future rate increases will probably get bigger and bigger if we don't do something about the escrow.

Let me just conclude by saying I am eager to work with the Administration on these issues because keeping the Postal Service healthy is a vitally important part of keeping our economy healthy. The mailing industry is nearly a $1 trillion a year business. I continue to be struck by the number of people that literally step out of almost everywhere and say how important Postal reform legislation is. I never imagined how many businesses and families are actually interested in what we are doing here. I am not sure that all of our colleagues are, but this is something that is vitally important to the economic lifeblood of our country.

We have been joined by Senator Stevens. I would just say to Senator Stevens, again, you are the father of our Postal Service. We have people called Solomon-like here. We had people called prophetesses, and we will call you the father of the Postal Service, because you are. The idea of leaving a legacy that endures for 3½ decades is just, I think, extraordinary, especially for something of this magnitude.

Let me close, Madam Chairman, just to point out that I realize our Postal reform bill does not satisfy all the stakeholders involved in this issue. It probably doesn't solve all the Postal Service's problems, either. Many of those problems will have to be solved by the Postal Service itself, and frankly, they are solving some of those—a number of those problems by themselves, and I give them high marks for that.

What the bill does do, I think, is to give Postal management the tools and the flexibility needed to run the Postal Service more like a business at a time when there is fierce competition from a whole lot of sources—E-mails, electronic bill payment, other forms of electronic communication, competitors who are carrying a lot of the materials that used to be, frankly, carried by letter carriers.

I think more importantly, though, our bill further shores up the Postal Service's finances, preserves its commitment to serve all the people in all of our communities.

Madam Chairman, I have enjoyed so much working with you and our colleagues. The only thing that I would enjoy more is getting a good bill on the President's desk that he would actually sign, and that is my commitment and I know it is one we share.

Chairman COLLINS. Thank you, Senator.

I do want to acknowledge Senator Stevens joining us. As my colleague said, he truly is the father of the modern Postal Service. I have also learned from our experience over the last 18 months why Postal reform is only successful once every 35 years, and this year is going to be the year. But we are very grateful to have him here with his expertise and experience, and I am particularly pleased to announce that Senator Stevens told me earlier today that he will join as a cosponsor of our legislation, and that certainly gives it a big boost, as well.

I am very pleased to welcome our first panel of witnesses. Timothy Bitsberger is the Assistant Secretary of the Treasury for Financial Markets. He serves as a senior advisor to the Secretary of the Treasury on a broad range of matters, such as domestic finance, financial markets, and Federal debt. Assistant Secretary Bitsberger is accompanied by Roger Kodat, the Deputy Assistant Secretary for Government Financial Policy.

Dan Blair is testifying on Capitol Hill for the second time today. He was at an Armed Services Committee hearing this morning. I hope, Dan, that you at least got time for some lunch. He is the Acting Director of the Office of Personnel Management. He was originally appointed as OPM's Deputy Director in February 2002. He has extensive experience in the civil service sector, and he served for, I believe, 17 years on the staff of this Committee and its House counterpart. So we are pleased to welcome you.

Mr. Secretary, we will start with you.

TESTIMONY OF TIMOTHY S. BITSBERGER,[1] ASSISTANT SECRETARY OF THE TREASURY FOR FINANCIAL MARKETS, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY ROGER KODAT, DEPUTY ASSISTANT SECRETARY FOR GOVERNMENT FINANCIAL POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. BITSBERGER. Thank you. Madam Chairman and distinguished Members of the Committee, thank you for the opportunity to testify today on the need for comprehensive Postal reform. I will summarize my written testimony and request that my full testimony be included in the record.

The President has articulated the need for comprehensive Postal reform to set the Postal Service on sound long-term operational and financial footing. My remarks this afternoon will focus on four of the Administration's five reform principles: Flexibility, self-financing, transparency, and accountability.

First, I turn to flexibility. Pricing is a key part of the flexibility that the Administration believes the Postal Service needs. We support a hard rate cap which provides that rates for any class of mail cannot rise more than the Consumer Price Index in any given year. We support the Committee's attempt to establish a hard cap at CPI and further support the Senate's version of an escape clause or exigency rate case which establishes a very high bar to increase rates above CPI.

[1] The prepared statement of Mr. Bitsberger appears in the Appendix on page 33.

We also seek to provide the Postal Service with flexibility on its cost side, as well. We note that the Postal Service's $66 billion cost base provides significant opportunity for cost reductions without jeopardizing service quality or its universal service obligation. While some may dispute the absolute size of the potential reductions, it is indisputable that productivity at the Postal Service has lagged the private sector by large margins and that more effective management practices should be able to make significant progress in this area.

Flexibility is not a blank check, though. The Postal Service currently has the ability to negotiate its portions of the premiums for health and life insurance for its employees. The Postal Service has taken advantage of this ability and negotiated benefits beyond those offered by the U.S. Government. Combined, the Postal Service has increased its costs for health and life insurance premiums by over $870 million annually above what the Federal Government pays for most of its other employees.

We have focused on a model where management has the flexibility to operate as a business within the constraints of a rate cap. This provides the right incentives for management and derives greater board and management accountability.

Now, I will turn to the principle of self-financing and the issue of the Postal Service's unfunded liabilities. The Administration believes that comprehensive Postal reform must require the Postal Service to color all of its financial obligation, including its on and off-balance sheet unfunded liabilities. It is important to recognize that since the 1970 Postal Reorganization Act, the Postal Service has never satisfied the statutory mandate of being fully self-financed. The Postal Service has accumulated approximately $75 billion worth of unfunded post-retirement health, pension, and workers' compensation liabilities.

The Postal CSRS Funding Reform Act has provided a unique opportunity to substantially improve the financial health of the Postal Service by dedicating all of the escrow to fund the unfunded post-retirement health obligations, which are approximately $64 billion. Without action, these unfunded liabilities grow to almost $100 billion in 2011 and over $1 trillion in 2045. We believe that the Postal Service should have a financing plan in place to ensure it can cover its post-retirement health care costs, and our proposal does just that.

We also recognize concerns from ratepayers over the 2006 rate case. The Postal Service has indicated that the need for the 2006 rate case is necessitated by the escrow established by the Postal CSRS Funding Reform Act, and that without access to the escrow, rates must rise to compensate. We believe that this analysis excludes the real reasons for the 2006 rate case. The reality is that any additional financing requirements of the Postal Service can be directly attributed to its inability to sufficiently reduce its cost since 2002, which is the date of the last rate increase. It is interesting to note that if the Postal Service had the authority to raise rates under the CPI capping proposed, the rates that would be in place today and in 2006 would be higher than what the Postal Service is currently proposing.

We note that personnel costs are projected to be $6.9 billion higher in 2006 than in 2002, despite lower head counts. And fuel costs are projected to be over $700 million higher. The point of highlighting these two line items, which combined are well over two times the $3.1 billion rate increase that the Postal Service is asking for, is to demonstrate that the rate increase has its roots in the Postal Service's general cost structure and is not linked to the escrow. To be clear, the amounts that constitute the escrow are in the rate base through all of the previous rate cases. The escrow amounts do not represent a new cost to be recovered.

The Administration understands the concern over the 2006 rate case, but we also believe that all escrow funds should be committed to paying down unfunded liabilities rather than diverted in order to minimize a near-term rate increase.

Transparency is another key principle framing reform. The Administration believes that real financial and operational transparency is essential to Postal reform. We seek to obtain this enhanced transparency through SEC reporting standards and a robust, independent regulator. We are pleased that the Senate has seen fit to adopt many of the Administration's recommendations in this area.

Financial transparency is important for ratepayers, taxpayers, competitors, employees, and management. With the expanded flexibility that the Postal Service will have on pricing discounts and service agreements, the Postal Service needs to fully understand the true financial implications of its decisions and needs to develop and instill a culture that measures and understands its costs at a very fine level, which is consistent with best practices in the private sector. Private sector companies generally produce product line financial statements for internal purposes, which include performance measurement and the pricing of products, services, and contracts.

Finally, I want to add a short thought on accountability. Accountability will result in many ways through our reform efforts. A hard rate cap that has a strict escape mechanism will drive management accountability. A strong regulator will drive accountability, and real financial transparency will drive accountability. The Administration looks forward to actively working with you to craft a comprehensive reform bill that will stand the test of time in an enormously dynamic market.

Thank you. I am pleased to answer any questions that you may have.

Chairman COLLINS. Thank you.

Mr. Kodat, it is my understanding that you are here to respond to questions but that you don't have a formal statement, is that correct?

Mr. KODAT. That is correct.

Chairman COLLINS. Thank you. Mr. Blair.

TESTIMONY OF DAN G. BLAIR,[1] ACTING DIRECTOR, U.S. OFFICE OF PERSONNEL MANAGEMENT

Mr. BLAIR. I see some familiar faces here this afternoon. Thank you for having me. Chairman Collins, Senator Carper, and Senator Stevens, thank you for permitting me to testify today on behalf of the Office of Personnel Management.

The President has laid out clear guiding principles for Postal reform legislation. You have made good progress toward incorporating many of the Administration recommendations consistent with these principles into your new Postal reform bill. However, the Administration still holds firm to the principle of self-financing as the means of ensuring the Postal Service continues to meet all of its obligations. That means revenue from ratepayers, not taxpayers, funds the employer obligations, including recognizing military service in its retirement funding planning.

The Postal reform legislation currently pending before the Senate runs counter to this principle. The proposal would relieve the Postal Service of $27 billion in pension obligations for funding military retirement credit for Postal employees covered by the Civil Service Retirement System. Legislation enacted last Congress reduced Postal pension obligations by $78 billion. That legislation provided a model funding structure for Postal pension obligations under the CSRS and provided appropriate pension relief.

Now, funding of Postal pensions is patterned after that of the Federal Employees Retirement System. FERS is a fully funded, actuarially sound pension system whereby all agencies are required to fully fund retirement costs, including all military service costs. Concerns have been expressed that that law singled out the Postal Service as the only agency required to fund military retirement credit for its CSRS employees. However, the USPS is different from other agencies and departments. It operates from revenues derived from the sale of its postal services and is required to fully fund its operations. Retirement funding is part of those operations. Covering the cost of employee pensions is a normal cost of doing business.

Since 1974, Congress has consistently singled out the Postal Service in requiring it to pay more of its retirement costs. Further, the Postal Service is not the only agency to fund the cost of military service under CSRS. Last year, the Patent and Trademark Office was required to fully fund its CSRS costs, as well.

Efforts to shift responsibility for fully funding Postal obligations from the Postal Service to Treasury represent a step backwards from sound pension funding and could potentially destabilize future retirement funding. Postal rate increases since the Postal Reform Act of 1970 have largely mirrored inflation. It is inaccurate to attribute any new Postal rate increase to the USPS paying for military service credit. The facts are that the USPS pension obligations have actually decreased due to the passage of legislation last year. Shifting responsibility for pension coverage does nothing to improve or increase Postal efficiency and does not represent any true reform.

[1] The prepared statement of Mr. Blair appears in the Appendix on page 39.

Your bill correctly requires the Postal Service to prefund its retiree health benefit costs, thereby recognizing and addressing these liabilities. However, the legislation would use retirement funds now allocated to address the military pension liabilities to pay for this. We believe prefunding retiree health benefits as provided in S. 662 is a responsible plan. We urge you to delete the provision using transfers from the retirement fund.

Madam Chairman, you and Senator Carper and the Members of this Committee have shown great leadership in taking on this complicated and contentious issue. We appreciate the opportunity today to participate in the hearing and your willingness to work with the Administration in an effort to enact true Postal reform legislation.

This concludes my statement. I would be happy to answer any of your questions.

Chairman COLLINS. Thank you very much, Mr. Blair.

Mr. Blair, as you know from your work at OPM, the Postal Service is required to give preference to veterans in hiring people to work for the Postal Service. Doesn't it seem to be unfair to require a preference to be given to veterans and then penalize the Postal Service by requiring it to pay for these veterans' military service when it comes time for them to retire, considering that if the same veteran went to work for HUD or HHS or the Department of Agriculture, those Departments would not be expected to bear that cost?

Senator STEVENS. May I interrupt?

Chairman COLLINS. Yes.

OPENING STATEMENT OF SENATOR STEVENS

Senator STEVENS. I have just been called as President Pro Tempore to go to the signing of some bills with the Speaker in the absence of the Vice President, but I want to add to that question. Have you studied the history of the change from CSRS to FERS? I was the author of FERS. It was understood at the time this veterans' preference would be carried forward. It did not have the burden of making this payment. That is something that has originated in this Administration, and I have notified the Administration time and time again that is wrong. We had an understanding at the time of veterans' preference.

If you hold to this position, we have thousands of new people coming back as veterans now. The Postal Service would be forced to limit the number of veterans they qualified because of this added burden. Now, it shouldn't shift the burden because of that. It is a privilege and a benefit for the veterans' service, for service in uniform, and it should not become something of an item that is going to stall this bill, and it will. It will stall the bill because I don't think we will approve that in view of the fact there is just this enormous group of veterans coming back to us from this combat activity we have now.

So I would urge you to rethink this. If necessary, I am going to ask to see the President on it, because I believe we had an understanding when we changed from CSRS to FERS, and we saved the Federal Government $8 billion in doing that. Now, there is no reason to shift back to the Postal Service a burden we did not anticipate at the time.

I am sorry I have to go——

Chairman COLLINS. Thank you for that strong statement. [Laughter.]

Senator STEVENS. My apologies to the Postmaster General. Thank you very much.

Chairman COLLINS. Thank you. Senator Stevens said it far more eloquently than I could have. [Laughter.]

Senator CARPER. Madam Chairman.

Chairman COLLINS. Senator Carper.

Senator CARPER. Do you think if Senator Stevens meets with the President to discuss this, that Senator Stevens will wear his Incredible Hulk tie?

Chairman COLLINS. I think he may well, and bring both of us with him.

Senator CARPER. Very good.

Chairman COLLINS. Seriously, this is an extraordinarily important issue, and we support that veterans' preference. But what you are doing is penalizing the Postal Service for following the law on veterans' preference and assuming an obligation that if that same veteran went to work for the vast majority of Federal agencies, that agency would not bear that cost.

Mr. BLAIR. I respectfully disagree, Madam Chairman. When new veterans come back from the war on terror and should the Postal Service follow the law as mandated, they would be hired under the Federal Employee Retirement System retirement plan, and under that plan, as has been since its enactment in 1987, those veterans would be receiving payments under FERS, and FERS was a fully funded system.

Chairman COLLINS. But I am not talking about FERS. I am talking about people who are under the old retirement system——

Mr. BLAIR. Well, the new employees would come in under FERS, not CSRS.

Chairman COLLINS. Right, but what I am talking about is the majority of the service that you are requiring the Postal Service to cover actually is World War II veterans, Vietnam War veterans, Korean War veterans, and the $17 billion is wholly retroactive, correct?

Mr. BLAIR. Well, it is wholly retroactive. That is correct. It is wholly retroactive because of the $78 billion credit that the Postal Service received was wholly retroactive, as well. When we did the Postal reform legislation 2 years ago, we looked at the Postal Service portion of the CSRS, and pursuant to a GAO request, we looked at it as if it was a fully funded system based on the FERS model, and we found that if it was based on the FERS model, that the Postal Service would be overfunding by $78 billion. And so in granting the Postal Service the relief from those liabilities, the Postal Service assumed $27 billion in liabilities associated with military retirement credit.

It is important to remember, too, that the Federal Government, even for CSRS employees within the Postal Service, is still paying $21 billion in military pension costs because that was—it was Postal service performed prior to 1971, when the Postal Service became the Postal Service, prior to that the old Post Office Department.

Chairman COLLINS. I think it is very important that I clarify the record. The $73 billion that you are referring to was to correct an overpayment into the system. It was an overpayment that was being corrected, and appropriately so.

What I am talking about in the $17 billion is the amount of payments that the Treasury made between 1971 and 2002. In other words, and would you agree that the Treasury has already made payments for the military service part of those Postal retirees' benefits?

Mr. BLAIR. Remember that $27 billion——

Chairman COLLINS. Could I ask you to answer the question and then go on?

Mr. BLAIR. Certainly. Those retroactive payments were to cover—there were retroactive payments requested, plus interest, but it was made in the context of the $78 billion which was forgiven to them. Remember that when we did the—when we based it on the FERS funding model, FERS covers the entire cost of the retirement plan. It doesn't parse out particular benefits, such as retiree COLAs or spousal benefits. It picked up the full cost of that.

And in going back to 1971, since that was the genesis of the Postal Service, we looked at that and we said, what would it look like if they were fully funded during that time, and if they were fully funded based on the payments that they had made up to that point, they would have—if they had continued that stream of payments, they would have overfunded by $78 billion. But in making those calculations, we also said that they would have to pick up costs that they hadn't previously picked up before because that is part of the dynamic funding that is part of the FERS funding model.

So it was part and parcel—it was part of an overall, comprehensive package of pension reform when the Congress enacted it a few years ago. It can't be considered outside of the context of the $78 billion because it was part of that. Otherwise, we would have given up relief of over about $105 billion.

Chairman COLLINS. Secretary Bitsberger, how is it fair to ask today's Postal ratepayers, today's Postal customers, to reimburse the U.S. Treasury for payments that were made years ago, that were made between 1971 and 2002 by the Treasury?

Mr. BITSBERGER. Senator, I think that we have been very clear here in our prior testimony on this matter. I agree with Mr. Blair. The Act of 2 years ago gave the Postal Service the $78 billion and incorporated with that was the military service.

Chairman COLLINS. Senator Carper, perhaps you will have better luck. [Laughter.]

Senator CARPER. Mr. Bitsberger, I think it is ironic that you are here representing the Administration—I don't say this in a partisan way—you are here representing an administration that has been part and parcel of pushing the unfunded coverage of Medicare to unquestioned heights. When people focus a lot about the unfunded liabilities that we have in Social Security, they are dwarfed by what we have in Medicare and the Administration that you are here representing today was part and parcel of pushing through the drug Medicare Part D program, which just explodes further the inability to fund Medicare. And you are here today literally contravening, contradicting what your own Presidential Commission recommended with respect to allowing the Postal Service to take some of these monies that they were in a position to recover and to pay down their health care costs. That may not seem ironic to you, but it seems terribly ironic to me. That is not a question, that is just an observation.

I want to go back to what the Chairman was saying. I served in Vietnam. We have a lot of people who are serving in Iraq and Afghanistan and places around the world. My parents' generation served in World War II and Korea. For the life of me, I don't see the fairness in saying that when my generation, my parents' generation, or the current generation is serving the people of this country in harm's way in many instances around the world, why when they go to work at the Postal Service, we expect the ratepayers to pay for the pension benefits that relate to their service for our country, their military service for our country. I don't see the fairness in that. The Presidential Commission that our President appointed, which did a very good job, they don't see the wisdom in that. What are we missing?

Mr. BLAIR. I don't think—I wouldn't characterize it as missing, but you have to keep in mind the Postal Service reaps—I think you would agree with me, the Postal Service reaps benefits through its employment of veterans.

Senator CARPER. I am sorry, would you come closer and speak more slowly?

Mr. BLAIR. I am sorry. I think you would agree with me that the Postal Service reaps benefits through its employment of veterans. In doing so——

Senator CARPER. Why should ratepayers pay for the military credit, the military years that I or anybody else has spent if we go to work for the Postal Service? Why do the ratepayers have to pay that? I am sorry.

Mr. BLAIR. For one, it is a cost of doing business. It is a cost of providing an employee benefit.

Senator CARPER. That is a cost to the taxpayers.

Mr. BLAIR. It is a cost of a retirement structure that has benefited the Postal Service. The Postal Service, I think, reaps enormous benefits through its employment of veterans. I think that has been well recognized, and I think in FERS, it has never been an issue. It is just when we recalculated and developed a new funding mechanism for its CSRS portion that this has become an issue.

Remember that under the old CSRS funding mechanism, it was done under a piecemeal basis. Congress mandated certain amounts would be picked up by the Postal Service, and that was an actuarially sound system, and we could have kept going under that system. But if you compared the old system to the FERS model, which is a good government model, which is a best practice model, you found that they would have been dramatically overfunding.

But we didn't pick and choose what they would be funding. We said, if you want to take the benefit of our analysis, take the benefit of a dynamic funding process, then you take the whole package. You don't pick and choose bits and pieces of the retirement plan you want to fund and what you don't want to fund. It doesn't pick and choose what bits and pieces of the retirement plan in FERS it wants to fund.

The Postal Service since enactment of FERS has been picking up the full cost of the military benefits, and I have not heard the discussion yet that the Postal Service should not be picking up that piece, either. We have a good funding model for CSRS. Frankly, CSRS, the rest of the government is dramatically underfunded in its CSRS portion, and we think that changes should be made about that, as well. But we have righted this system, and we ask Congress not to take steps that would underfund and be to the detriment of the retirement fund and future retirees.

Senator CARPER. Let me back up just a little bit. The Postal Service has been able to—I see we have been joined by General Potter. The Postal Service under his leadership and the Board of Governors—and thanks to a lot of sacrifice on the part of the employees—has been able to begin doing some interesting things. They have been able to start paying back their debt to the Treasury, paying down their debt substantially. I think they have been able actually to use some money to address the unamortized health care costs for their pensioners, and it is because of the work of a lot of people. Some are in this room, but a lot are not.

We are in a situation where, for years, we thought the Postal Service was underpaying their pension obligations. Then we find out that no, they weren't underpaying, they are overpaying their obligation. So they had the opportunity to adjust that payment. And what they are doing is using, I believe, the savings from adjusting that payment to begin paying down their debt to the Treasury, begin meeting their health care obligations. What is wrong with allowing them just to go ahead and do that?

Mr. BITSBERGER. Senator, we view this as the principles for self-financing and the model for self-financing. I think that what we are trying to do is be able to mitigate future rate increases by acknowledging that these future unfunded liabilities exist. I think it is important to note that we need to kind of disassociate the escrow from the proposed rate increase for 2006.

No one wants to see a rate increase here. What we are trying to do is mitigate and lower future rate increases by acknowledging that that escrow can be suitably used to pay down these future unfunded liabilities.

Senator CARPER. Madam Chairman, my time has expired. I am going to slip out of the hearing for a little bit. I will be right back.

Chairman COLLINS. Thank you.

Senator CARPER. Thank you.

Chairman COLLINS. I am going to pursue this issue a little bit further. Mr. Blair, in your statement, you used the Patent and Trademark Office as an example of an agency that now was going to be required to pay the full costs of the CSRS benefits, including the military service credit. Isn't that on a prospective basis?

Mr. BLAIR. Yes, it is.

Chairman COLLINS. Do you know of any other entity, other than the U.S. Postal Service, that is required to bear this cost retroactively?

Mr. BLAIR. I would have to look—I would have to answer more specifically for the record, but I am not aware of any, but I am not aware of any other entity that has had the benefit of a pension analysis to look at their previous payments to determine that kind of overfunding, which the Congress addressed 2 years ago, either.

Chairman COLLINS. Well, I would say that the Committee staff has done an extensive analysis and we know—the Committee knows of no other agency or Federal entity belonging to the CSRS system that is bearing this cost retroactively. I believe that your further review will confirm that the Postal Service is unique, but I do look forward to hearing back from you on that point.

Mr. BLAIR. I think the main point on that is that you can't consider those retroactive payments outside the scope of the retroactive benefit that was afforded the Postal Service in terms of the $78 billion. We looked at those payments that they had made and we went back to 1971 and credited them with past interest. No other agency made payments like that. So they are, indeed, unique in that respect. But to argue that—they are going to get the benefit of retroactive interest credits, then they need to pick up the liabilities associated with past payments that they did not make.

Chairman COLLINS. Well, let us talk about that. In other words, Postal customers past, present, and future have paid, and under the law will continue to pay, too much in rates to the tune of $73 billion, or your figure is $78 billion. What I hear you saying today is you want that $73 to $78 billion to keep flowing into the Treasury, at least in the short term, so that it can be used for anything and everything wholly unrelated to the Postal Service and affecting a $900 billion mailing industry that is critical to our economy.

Mr. BLAIR. What we would propose, and as you have in your bill, is a post-retirement health benefits fund that that money would flow to to begin recognizing almost $64 billion in accrued liabilities and to prevent future rate cases, not just the 2006 rate case, but future rate cases and future ratepayers from having to suffer a huge hit that would be required in order to make payments on a pay-as-you-go basis under the system that was previously in place.

Chairman COLLINS. As you know, our bill does call for pre-funding some retiree health benefits, but we don't say that every dollar has to go for that purpose, which is the Administration's position. Instead, we recognize that the Postal rate consumer, who has been overpaying, ought to share in this funding and that would help the Postal Service avoid rate increases that really are not warranted if this problem were straightened out.

Secretary Bitsberger, let me ask you, has the Treasury done any economic analysis of the impact of the rate increases proposed by the Postal Service, rate increases that would not be necessary if this bill becomes law?

Mr. BITSBERGER. Not per se. The rate increase that they proposed was 5.4 percent. I believe the CPI over the corresponding period, from June 2002 to the corresponding date, is roughly up 12.4 percentage points. So they are well within a CPI cap if that had existed previously. So the Postmaster General should be commended for staying well under CPI.

I think that the harm, if there is any harm to the economy, it would come in the future where large unfunded liabilities could cause unpredictable and excessive rate increases. I think the ability to—and through the transparency have the hard CPI cap combined in concert with the escrow will allow the Postal Service to best manage its costs and its liabilities together over time, further mitigating any potential—any rate increases on the economy at that point in time.

Chairman COLLINS. You know, I would really encourage you to look at the hearing records from the eight hearings that we have held on this issue. I think you would be astounded to learn of the impact of Postal rates on so much of the economy. The CEO of *Time Magazine*, for example, testified that postage is her single largest line item. It is more than the cost of the paper that *Time Magazine* is printed on. It is more than the cost of printing the magazine. It is more than the labor costs, which probably dismays some of their reporters.

It has an enormous impact. I gave you the example of a small manufacturer in Maine who had a catalog company and thus could not increase prices because they had already been printed in the catalog. I really urge you to think more thoroughly about the economic impact of Postal rate increases. It ripples through the entire economy. It affects a $900 billion mailing industry. It affects everything from catalog companies to newspaper publishers to credit card companies, anyone who is a heavy user of the mails. And that means ultimately it affects jobs, and that is what it is all about.

So I just want to encourage you all to continue to work with us. I do thank you, and I hope you do acknowledge that the Committee's bill this year is different from last year. We incorporated many suggestions from the Administration that I believe strengthen the bill, such as the transparency provisions, the SEC-like disclosure provisions, the CPI cap. I can tell you that the Postal Service is not always happy that we included all of those provisions. The Postal Service is vital and the Administration needs to come up with potential compromises on the remaining issues about which we disagree.

Mr. BITSBERGER. Thank you, Senator. I would like to thank you and your staff for working so closely with us on this. I think that real progress has been made and we are very encouraged by all the progress to date, so thank you and your staff and others, as well.

Chairman COLLINS. Thank you. I want to thank this panel for being here today. We look forward to continuing to work with you to resolve the remaining issues to the Committee's satisfaction.

I would now like to welcome our second panel of distinguished witnesses to the hearing. Postmaster General Jack Potter has testified before this Committee at one of our very first hearings on Postal reform back in November 2003, and we appreciate the expertise he brings to this issue.

David Walker is the Comptroller General of the Government Accountability Office. He is perhaps our most frequent witness before this Committee, and the insights that he and the GAO staff bring to our proceedings are always appreciated.

I want to thank the Postmaster General for changing his schedule to be here today. I know that he was previously scheduled to be, I believe, in Texas before a large group of Postal customers, and we very much appreciate his rearranging his schedule. I would ask him to proceed.

TESTIMONY OF HON. JOHN E. POTTER,[1] POSTMASTER GENERAL, U.S. POSTAL SERVICE

Mr. POTTER. Madam Chairman, I did make it to Houston, Texas, and thanks to some very considerate customers of ours, we had a nice 7:45 a.m. conference, so I did get an opportunity to speak to over 500 customers down there, so thank you for having this hearing in the afternoon that enabled me to do that. I appreciate it.

And good afternoon, Madam Chairman. Thank you for this opportunity to continue the critical discussion about the need for comprehensive Postal reform legislation. I want to thank you in particular for your personal commitment toward this effort. I am also grateful to Senator Carper and the other Members of the Committee for their support and hard work to try to move us closer to legislation that will protect and preserve universal mail service for all Americans well into the future.

As the process toward legislative reform has continued to advance, the Postal Service has continued to pursue the goals outlined in our transformation plan, that is, to improve service and bring about changes that are within the framework of our current legislation. I have included a detailed report of the progress that we have made over the last 4 years for the record. Suffice it to say, we are transforming the Postal Service. We continue to develop new ways to improve service, to reduce our costs, to increase efficiency, and add value to the mail. We are currently updating our transformation plan to include initiatives for improvements that will carry us through 2010.

Yet despite our best efforts to transform the Postal Service, these successes only mask the underlying dilemma that, in the future, jeopardizes our ability to continue to provide affordable universal mail service to the American public. To put it plainly, we are seeing continued erosion of high-margin First-Class Mail, which the framers of the Postal Reorganization Act viewed as the primary revenue source to support the national commitment to universal mail service.

First-Class Mail volume dropped 6 billion pieces from 2001 to 2004, mostly due to the diversion to electronic alternatives. This diversion threatens to siphon off a significant segment of First-Class Mail that contains financial transactions, most commonly bills, statements, and payments, which last year accounted for about 50 percent of all First-Class Mail. The potential loss of revenues from financial transactions could run as high as $16 billion annually.

On the other side of the ledger, our expenses continue to rise. Our delivery network continues to grow annually at about 1.8 million new addresses, which requires added delivery routes, additional employees, added vehicles, and thus increased costs. The net effect is that we are delivering fewer pieces of First-Class Mail to more addresses.

This dilemma is compounded by the fact that the business model created by the Postal Reorganization Act of 1970 does not provide

[1] The prepared statement of Mr. Potter appears in the Appendix on page 45.

the flexibility and mechanisms needed to resolve this imbalance going forward. At some point, we will simply run out of acceptable options, which heightens the urgency for Postal reform legislation in a new business model, one that will give us the tools we need to break through this logjam and give us the flexibility we need to operate in a more businesslike manner.

It is with that sense of urgency that I want to reiterate the points cited by the Board of Governors of the Postal Service last month as key components of Postal reform legislation.

First, in the matter of the escrow requirement and the military service requirement obligation in Public Law 108–18, we maintain that the escrow provision should be eliminated and that the Civil Service Retirement System military obligation should be returned to the Department of the Treasury. Therefore, we support the provision of the Postal Accountability and Enhancement Act, S. 662, which returns the military obligation to the Treasury and creates a deposit of $17 billion in a retiree health benefit trust fund and provides a 40-year amortization payment schedule to fund retiree health benefits.

Second, comprehensive legislative reform should incorporate changes in the area of labor, which accounts for almost 80 percent of our cost. Provisions in S. 662 that make changes to workers' compensation are very much appreciated. However, under current law, about 25 percent of our compensation costs, that is, benefits portion, are exempt from collective bargaining. We are not seeking to cap or restrict craft employee wages. Rather, I believe wages, benefits, working conditions all should be negotiated with our unions. We also believe that the regulator should not—I repeat, not—be given the power to determine the range within which wages can be negotiated.

Third, the Postal Service should be granted the authority to change rates and introduce new Postal services both with the approval by the Board of Governors and within a price range determined by the regulator without prior approval. If the Postal Service had the authority to adjust rates within a predetermined range, we believe that CPI could serve as an acceptable, though challenging, price cap.

Let me add that a price cap formula must have balance, balance that provides management with flexibility in pricing, with freedom to modernize infrastructure, with the ability to negotiate costs, be they employee benefits, vendor contracts, or air transportation charges. Balance in any price cap formula should also set standards that allow management to accommodate unforeseen economic pressures, such as escalating energy prices or steep, dramatic reductions in mail volume. To that end, the inclusion of a reasonable exigency provision is essential in any bill that provides for a CPI rate cap.

Chairman Collins, we also appreciate very much that S. 662 calls for the application of the price cap at the class level.

Finally, with regard to any future changes in the scope of the Postal monopoly, we believe that the Congress, not the regulator, should determine the appropriate national public policy within the context of the Postal Service's universal service mission and other social obligations.

Chairman Collins, we are ready, willing, and able to step up to the challenges that confront us in the years ahead. At the same time, we do not want to return to the days prior to Postal reorganization when America's mail system was dependent on an annual infusion of tax dollars to make ends meet. But neither can we rely on a 34-year-old business model that was created at a time when there was no national competition or competitive services nor electronic alternatives, and when it was assumed that First-Class Mail volume would continue to increase to support a continually growing delivery network.

The long-term solution must be a fundamental restructuring of the legislative and regulatory framework. Effective and meaningful reform can only be achieved if it provides balanced solutions to the complex problems we continue to face. A piecemeal approach will not get us to where we need to be 10 years down the road. There is an essential interdependency that exists between the key legislative components that I have described.

The current bill must strike a reasonable balance between necessary controls and essential freedoms and flexibility we need to bring about real reform. Those key elements are the flexibility to use pricing as a tool to remain competitive and to grow the business; the flexibility to provide new services and products that will meet the changing business needs of the Nation and the needs of the American consumer; the ability to negotiate all employee benefits; the ability to manage our infrastructure and adjust our networks to keep our costs under control; and a regulatory environment that protects the interests of our competitors and addresses issues of transparency, but one that also fosters innovative changes and more efficient processes instead of more bureaucratic entanglements that can only retard progress.

At the end of the day, with these legislative components to guide us, we will be able to continue to provide affordable universal mail service to the American public well into the future. Along with the Governors of the Postal Service, I look forward to working cooperatively with you, with the House, with the Administration in this vital and critical work of defining the reform measures necessary to head off the dire consequences that await us all if we fail in our task.

Thank you, and I will be pleased to answer any questions you may have.

Chairman COLLINS. Thank you. Mr. Walker, we are very pleased to have you here today. Given your great understanding of financial issues, I hope you can shine some light on our previous discussions and we look forward to your testimony.

TESTIMONY OF HON. DAVID M. WALKER,[1] COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. WALKER. Chairman Collins, I think I can help you in that regard. Let me at the outset say thank you for the opportunity to be back before this Committee to once again speak about the need for Postal reform. Congratulations go to you and Senator Carper

[1] The prepared statement of Mr. Walker appears in the Appendix on page 64.

for your leadership in this regard. I think you and your staff have done an outstanding job to date, and I am hoping that we can bring this ship home before too long.

I would respectfully request that my entire statement be included in the record.

Chairman COLLINS. Without objection.

Mr. WALKER. Thank you. Therefore, I will move to summarize.

The Service has made significant progress since fiscal year 2001, including achieving record net income, repaying debt, achieving additional productivity increases, and downsizing the Postal workforce. I think the Postmaster General, Jack Potter, ought to be commended for the work he and his key players have done at the Postal Service. They have really done an excellent job with the flexibilities that they have.

However, I think it is also important to note that most of the net income that occurred was due to the passage of the law in 2003 that corrected the formula for contributions for pensions. As you properly pointed out, Madam Chairman, the situation there was to correct the formula to make sure that the Postal Service paid for its full obligations, not more and not less. I will come back to the issue of military service in a few minutes, with your indulgence.

Despite the progress that has been made, comprehensive Postal reform legislation continues to be needed in order to address certain fundamental financial, operational, governance, and human capital challenges that continue to threaten the Service's long-term ability to maintain a self-supporting structure while providing high quality and universal Postal service at an affordable cost. The Postal Service has done a lot; however, many things remain to be done. This sounds like a typical GAO report. But they are going to need your help, because there is absolutely no question that legislative reform is still needed in several areas.

Certain key areas for Postal reform include clarifying the Service's mission and role so that the Service remains focused on universal Postal service and competes appropriately; enhancing the Service's flexibility to operate in a businesslike manner with a governance structure suitable for a $70 billion entity, balanced by enhanced transparency, accountability, and oversight. The Service also needs to make needed human capital reforms and move toward prefunding certain significant post-retirement obligations, in particular their retiree health obligations.

Madam Chairman, postal reform is needed to address the following key areas. Mission and role—to clarify the Service's mission because the current law has enabled the Service to engage in unprofitable activities that are unrelated to its core mission, as well as to clarify the Service's role in competing fairly, including its monopoly power, its authority to regulate the scope of its own monopoly, and other terms of competition.

Second, governance, transparency and accountability. Congress needs to delineate the Service's public policy, operational and regulatory responsibilities. It needs to ensure managerial accountability for a strong, well-qualified corporate-style board that holds its officers responsible and accountable for achieving results, not just currently, but over time, and to define appropriate reporting mechanisms to enhance the Service's transparency and accountability for its financial and performance results.

With regard to flexibility and oversight, Congress needs to balance increased flexibility for the Service to operate in a business-like manner through streamlining the rate-setting process and allowing a certain amount of retained earnings while enhancing oversight by an independent regulatory body to protect Postal customers against undue discrimination, restrict cross-subsidies, and ensure due process. In addition, the Service needs additional flexibility and incentives to rightsize its infrastructure and reshape its workforce. Such additional flexibility in these areas should be balanced by safeguards to prevent abuse as well as to enhance transparency, accountability, and oversight, starting with appropriate disclosure of the Service's large financial liabilities and obligations, much of which are currently not on the Service's balance sheet.

Human capital reforms and pension benefit costs are also important. Congress needs to consider legislative proposals that will revise the Service's current responsibility for pension costs related to military service. In that regard, Madam Chairman, two concepts that I would respectfully request that this Committee and the Congress consider, which also apply in accounting. The first concept is matching. The second is consistency.

With regard to matching, who benefited from the military service? The cost should be matched with the party who benefited from the military service. I would argue that all Americans benefited from the related military service.

And second, consistency. To what extent are other entities that are government corporations required to bear such costs? For example, neither the PBGC, which I used to head, nor the FDIC, which we do the audit for, have responsibility for these military service costs.

So I would respectfully suggest you may want to consider the concepts of matching and consistency, and I would respectfully suggest that the Administration needs to do the same.

I think we also need to move toward prefunding of retiree health benefits and the need to abolish the escrow account established in recent postal legislation.

In any event, progress continues to be needed toward a more flexible, contemporary, performance-oriented, market-based compensation system for all Service employees consistent with proven approaches in the human capital area. In that regard, I would note, Madam Chairman, that there is nothing in the current bill that deals with the pay comparability issue, which I think is a very real and important issue. There is also nothing in the current bill that deals with the issues that the Postmaster General touched on, namely the ability to negotiate benefits, which represent a major and growing portion of total compensation, given health care and other types of costs.

In closing, let me again compliment you, Madam Chairman, and also Senator Carper on your leadership in this area. I have had an opportunity to look at S. 662 and consult with my staff. Based on the work that has been done to date, I think you have come up with a reasoned and reasonable framework for Postal reform. There absolutely is a need for Postal reform, and we look forward to working with you, your staff, and others to make Postal reform become a reality in this Congress.

Thank you, Madam Chairman.

Chairman COLLINS. Thank you very much, Mr. Walker.

The two principles that you laid out for the Committee of matching and consistency are very helpful guidelines for us to follow, and I appreciate your suggesting those guidelines to us.

Mr. Walker, I just want to reemphasize a point that you made, and that is despite the hard work of the Postmaster General, the employees of the Postal Service, and the managers of the Postal Service, Postal reform is still very much needed. This cannot be done just administratively.

Last time you testified before us, you said that if we do not act, the risk is that we will face either dramatic rate increases with the resulting detrimental impact on the economy, or the risk of a significant taxpayer bailout if legislation is not enacted. Is that still your assessment?

Mr. WALKER. That is still true, Madam Chairman, and I would also note that there are some analogies here between the Postal Service and Social Security. If we take last year, for example, the Postal Service ran about a $4 billion surplus, I believe——

Mr. POTTER. Three.

Mr. WALKER. Three. Well, I am sorry, Jack. [Laughter.]

He did a great job, but not quite as good as I thought. [Laughter.]

So a $3 billion surplus. Social Security ran a $151 billion surplus. But if you look in the out years, based upon known commitments and obligations, and in the case of the Postal Service, these huge retiree health obligations, which have gone up since the last time that we talked, these are temporary surpluses. There is absolutely no question that reform is necessary, and if reform doesn't come, those two possible undesirable outcomes are still real possibilities.

Chairman COLLINS. Thank you. I think that is a very important point, and I have heard you also make this point with regard to entitlement programs in general, that the longer we delay, the more difficult it is to put the Postal Service on a firm financial footing so that it can go forward. So sooner rather than later, I assume, is also better.

Mr. WALKER. I agree, and there is another important point, Madam Chairman. Namely, nobody likes a rate increase. Nobody likes a tax increase. Nobody likes a fee increase. However, I think that we have to recognize reality. I believe it is better to be able to have modest, moderate, and predictable postal rate increases so the private sector can manage their costs, rather their experience large, unpredictable, and more frequent rate increases.

Therefore, I commend the Committee for recognizing that while relief on the pension side has occurred, and you obviously have to decide what to do with military pensions, there is a need to begin to fund the retiree health obligations because in the absence of doing that, you are going to create tremendous pressure for much larger and more frequent increases in the future absent taking that step.

Chairman COLLINS. Thank you. You know, as I was listening to our previous witnesses, I couldn't help but think that in some ways, this is a shell game. It is not as if the escrow account would be transferred to a Bank of America account marked "U.S. Postal Service." It is really a matter of Postal ratepayers subsidizing the current Federal balance sheet.

Mr. WALKER. Well, unfortunately, as you know, we are investing in most cases in trust funds or escrow accounts in non-readily marketable government bonds that are backed by the full faith and credit of the U.S. Government, but in the end, those bonds have to be paid off. In order to pay them off, you have to raise revenues, cut other spending, or increase debt held by the public. And as you properly pointed out before, we are currently on an imprudent and unsustainable fiscal path. It would be great if we could help the Postal Service be better positioned for the future. Quite frankly, while Postal reform is a challenging undertaking, it is a modest undertaking compared to Social Security, Medicare, and other types of challenges that we face.

Chairman COLLINS. Mr. Potter, the previous witnesses referred to a rationale for treating the Postal Service differently that was based on the Postal Service having received billions of dollars in appropriations. It is my understanding, however, that the $9 billion that was a public service appropriation that was authorized in the 1970 Act has not been requested or received since 1982 and that the limited funding that the Postal Service has received from the Federal Treasury has been based on public policy written into law, for example, to cover the mandate that we have required for reduced rates for mailings to people who are blind, for example. Is that correct? I just think it is really important we clarify this.

Mr. POTTER. That is absolutely correct. Since 1982, we have not asked for an appropriation to help us provide delivery services, and it is our intent, and I know it is the intent of this Committee, not to have the Postal Service get into a position of having to ask for that in the future. That is why it is so essential that we make these changes now, to avoid that calamity.

Chairman COLLINS. And with the exception of federally mandated rates, such as in that area, the goal really should be that the Postal Service does not subsidize the Treasury and the Treasury does not subsidize the Postal Service. I mean, it goes both ways, does it not?

Mr. POTTER. I hope so. [Laughter.]

They have a little more power than we do.

Chairman COLLINS. I can understand why the previous testimony might create some doubt in your mind, since it essentially was proposing that the Postal Service and its customers subsidize the Treasury, which is disturbing and unacceptable to me.

If this legislation passes, what would be the impact, if you can comment on this, on the pending rate case?

Mr. POTTER. Well, it would be a function of what is passed. For example, if the Senate bill were passed, obviously, there would still be a cost in 2006 that we don't bear today. That cost would be slightly lower than what is in the escrow account. So we might modify that rate increase slightly. But the beauty of what has been proposed in the Senate is that the costs going forward are linked to our health benefit obligations. So in effect, you have a flat payment stream——

Chairman COLLINS. Like a mortgage, in some ways.

Mr. POTTER. Like a mortgage, and it is amortized over 40 years, and it is reevaluated, actuarially reevaluated, year by year. But in effect, you have a flat payment stream, like a mortgage.

Paying or repaying the escrow money into a health benefit fund, there is no linkage to the cost for health benefits and that payment would rise every year and that increased payment—it would start at $3.1 billion in 2006 and rise to over $7 billion in 2010—each year, that puts added pressure on rates and on the Service.

So the notion that the military obligation remains in the Treasury, that the excess funds serve as a downpayment on, or serve as, in effect, the downpayment or as capital that is now available for future retiree health benefits and that we add to that every year is a notion that we embrace, and we embrace the model that has been proposed under S. 662 as one that is very workable for the Postal Service. It addresses our long-term obligation. At the same time, it is done in a way that does not put rate pressure on every year after year. It builds it into the base and it allows for it to continue going forward.

Chairman COLLINS. Finally, before I turn to my colleague for his questions, could you give us a better understanding of the economic impact if rates spiral upward, say double-digit rates, which we were very worried about a year ago?

Mr. POTTER. Well, let me first give credit to all of the Postal employees for their hard work in changing our processes and embracing the notion that we had to become more efficient. Their hard work, their efforts have enabled us to avoid a double-digit rate increase, and I think part of the motivation was that we explained to them that a double-digit rate increase would have mail moving away from hard copy to other media, and they understood that and they recognized that was a challenge that we faced. They embraced the notion of that challenge and they got on board when it came to making adjustments to our system to increase value of the mail. That was not only from a cost side, but a service side.

But each product that we have has an elasticity, and so as we raise rates, if we have a double-digit rate increase in, for example, Priority Mail, we can expect a double-digit loss in volume. And so our products are very sensitive to price. People make decisions, for example, on advertising. Do they use the mail? Do they use radio? Do they use television? Do they use newspapers? And they do calculations based on cost and return.

So anytime you see a dramatic jump in price, obviously, it affects the economics of using the mail versus using alternatives, and we don't have the monopoly that we had in the past because there are alternatives to every product and service that the Postal Service has.

Chairman COLLINS. I think that is a very important point for me to end my questioning on. It brings to mind the memorable phrase of Mr. Walker in which he described the potential death spiral of the Postal Service, where you increase your rates sharply. Volume then falls, but you are still serving the same number of addresses, so then you have to increase your rates to cover your costs. Volume falls again. That is what we must avoid, and that is why I am so committed to getting this legislation passed. I believe it will give you the tools you need to have affordable, predictable rates, and that is really key.

Senator Carper.

Senator CARPER. Thanks, Madam Chairman. I understand that the gentlemen had an opportunity to respond to some of the comments of the previous panel with respect to military service?

Chairman COLLINS. Yes.

Senator CARPER. Did this panel acquit themselves pretty well?

Chairman COLLINS. They did, indeed. [Laughter.]

You will be surprised to learn that they have a different view. [Laughter.]

Senator CARPER. Well, I am surprised. No, not really.

Gentlemen, welcome. Thanks very much. I had an opportunity, General Walker, to talk with the other General, General Potter. These generals, it is almost like an Armed Services Committee hearing. [Laughter.]

Mr. WALKER. You don't have to salute us, though, Senator. [Laughter.]

Senator CARPER. Well, I do anyway.

About the growth in one of the products, it is actually a fairly new product, what do you call it, where people have somebody come by, their letter carrier come by——

Mr. POTTER. Click and ship?

Senator CARPER. What is it called?

Mr. POTTER. Click and ship, where people can get online and——

Senator CARPER. Just take a moment and share with us again the growth in that product, the acceptance by households and businesses.

Mr. POTTER. Well, we have seen a dramatic increase in the amount of people who get online, access our website to produce labels for any packages that they have. They pay for postage. We give them the opportunity, since for security reasons we can't allow them to put packages in collections boxes, the opportunity to tell us that they have a package and they would like our carrier, or their carrier, to stop by and pick up their package the next day. They can get insurance online for that package. They can put tracking and tracing on that package.

And what we are seeing is, again, a dramatic increase in the amount of folks that are using that service. On a daily basis, we are picking up thousands of packages that in the past, we wouldn't have been able to provide the convenience to our consumers, to our customers. So we basically use the Internet to provide services, another means of access to provide services for our customers where they live, where they work, and I think we have—probably are uniquely suited to provide that, since we are at every door every day.

Senator CARPER. When I heard that, it was kind of an "aha" moment for me. I said, that is it. I don't know if that is the future, but that is part of the future, and it is the kind of creativity that we are looking for. Whatever smart people within or outside the Postal Service who came up with that idea and who have nourished it and grown it, I just say, keep it up.

A couple of questions. I will start, if I could, General Walker, with you. First of all, a question or two about the rate cap. The rate cap that we have included in S. 662 takes, we believe, into account some of the Postal Service's main cost drivers, I guess such as fuel, such as employee health care costs. We believe it takes those into account sufficiently, and I would just ask your take on that.

Mr. WALKER. Let me commend you, along with Chairman Collins, for your leadership in this area. I think you have done a great job of getting to where we are right now.

Senator CARPER. We are only as good as our staff, and we have had excellent staff people.

Mr. WALKER. And your staff, too. That goes without saying. I did say that before, but you are right to——

Senator CARPER. I really appreciate your saying it again, too.

Mr. WALKER. My understanding is your rate cap is CPI, and you can't do anything other than CPI unless it is unexpected and extraordinary. The only concern that I have, and I haven't run the numbers on this and I don't know if your staff has run the numbers on this, is obviously we don't know how the issue is going to come out on military retirement, but we know that there is a huge number for retiree health care.

I think one of the things that is important to look at is to make sure that the known costs for retiree health care are considered with regard to this cap. It is known. It is expected. It is not extraordinary. And so, therefore, I would hope that this cap would be able to consider that known, expected, and non-extraordinary item. I just haven't run the numbers. I do, however, think the concept of having a cap is one that has significant conceptual merit.

Senator CARPER. Just sort of related, assuming that the rate cap in S. 662 is actually enacted into law, other than the point you just raised, are there any other impacts that come to mind that are going to have an adverse effect, particularly adverse effect, on Postmaster General Potter, his successors, or others that work with him? Anything else that comes to mind?

Mr. WALKER. There are two areas that I mentioned before, Senator, that are not currently in S. 662 which I would respectfully suggest that you consider.

One is the issue of pay comparability. That is a real and important issue.

The second is the issue of being able to bargain over total compensation, which includes benefits. Benefits are becoming an increasingly significant percentage of total compensation, and they are a big driver to long-term cost. I would respectfully suggest, as Postmaster General Potter alluded to, that all individuals who work for the Postal Service have a shared challenge and have a mutuality of interest to try to make sure that this business model is modified as necessary and that costs are moderated going forward. A big part of the costs of the Postal Service are compensation costs, and compensation costs aren't just pay, they are also benefits. I would respectfully suggest that these are two issues you may want to think about. If you don't have a cap, I think it is going to be even more important that you consider them.

Senator CARPER. If I could just stay with this rate cap, General Potter, for just a little bit longer, you stated in our meetings, and I think probably here today before I got here, that the Postal Service could probably live within a rate cap based on CPI but that you need more ability to break from that rate cap from time to time than is inherent in the provision in our bill.

Let me just ask, under what circumstances do you think the Postal Service might need to break the rate cap, and the second question is, why can't the kind of cost drivers that might lead to your breaking the rate cap be accounted for in a rate that falls under the CPI-based cap?

Mr. POTTER. Senator, the biggest challenge we have is the loss of volume, and I think as I alluded to in my opening remarks and as Chairman Collins alluded to in her spiral discussion, the loss of volume is really the challenge that we are most concerned about when it comes to the future.

We are anticipating that there will be a normal decline in volume, or relatively graduated decline in volume versus a steep decline. If there were to be a steep decline in volume in any given year, that would be something that would put a lot of pressure on the Service, and one of the options should be to go back to the regulator and seek relief.

I would like to pick up on a point that General Walker just talked about and that is the notion of our acceptance or our commitment and our agreement to go ahead with CPI. One of the expectations of that agreement was that we were going to have a flat payment schedule when it comes to contributions to retiree health benefits. Just think about the numbers.

In 2006, our payment under the Administration's proposal will be $3 billion. In 2016, it will be $7 billion. So, in effect, every year, that payment is going up, on average, $400 million. Well, where is that coming from? That is—$400 million on a $70 billion base is better than half a percent. So if you are capped at CPI and a half a percent is already earmarked for retiree health benefits, and then on top of that, under their proposal, you are paying for retiree health benefits and they are rising at 15 percent a year, and our employee health benefits are rising, the people on the rolls are rising 7 to 12 percent per year, you start to realize that there are a lot of costs that are above inflation.

And so the notion going forward, if we could look ahead and say, is everything rising at inflation? Well, the fact of the matter is, it is not. It is rising above inflation in many areas, and we recognize, as was stated earlier, there are efficiencies that can be gained. We want to aggressively pursue them. There are mechanisms to raise revenue. We are looking for pricing freedom to do that. And what we are trying to seek is a balance, a balance between those cost drivers that are above inflation and our ability to mitigate costs and become more efficient and change our processes.

But there will come a time when they don't match. What lies in the balance? In my mind, I see it as a three-legged stool. There is revenue, there is cost, and then there is service, and we want to keep those three things in balance as best we can, and there may come a time when, not because of something that is extraordinary but just kind of in the normal business flow, business cycle, would have us want to exceed a CPI cap.

I don't envision it in the next 3 to 5 years, but I think if we put our caps on and say, what is going to happen 15 years from now, I think it is easy to envision that whoever is running the organization might seek and need to seek that relief.

Chairman COLLINS. I want to thank our witnesses for being here today. It has been very helpful to have your testimony.

Senator Carper and I are very committed to getting this legislation signed into law this year and we are going to need your help and your advice and expertise as we continue to work on this important legislation. I do want to thank all of our witnesses for being here today.

This Committee has made Postal reform a priority. It remains a top priority for us, and we will be moving forward on this. The only other issue that we have had as many hearings on as this issue was the intelligence reform bill, and that became law when people didn't think that it would, also. So I am equally committed to getting this bill signed by the President.

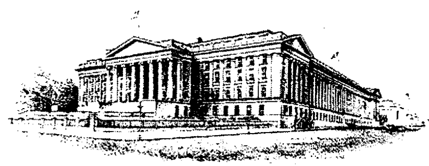
The hearing record will be held open for 15 days for the submission of questions or other materials.

I do want to join my colleague in thanking the Committee staffs and your staffs for their hard work.

This hearing is now adjourned.

[Whereupon, at 3:53 p.m., the Committee was adjourned.]

APPENDIX



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

Embargoed Until 10 a.m. EST
April 14, 2005

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HEARING TESTIMONY
THE HONORABLE TIMOTHY S. BITSBERGER
ASSISTANT SECRETARY OF THE TREASURY FOR FINANCIAL MARKETS
ON REFORM OF THE UNITED STATES POSTAL SERVICE
BEFORE THE
COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

Madam Chairman and distinguished Members of the Committee, thank you for the opportunity to testify today on the need for comprehensive postal reform. I welcome this opportunity to underscore the Administration's strong interest in enacting comprehensive legislation to reform the United States Postal Service.

The Administration Supports Enactment of Postal Reform

The President has consistently articulated the need for comprehensive reform to set the Postal Service on sound, long-term operational and financial footing. The Administration has been holding regular meetings with Congress and many stakeholders to ensure that we hear everyone's perspective and that our message is heard as well. I would like to extend the Administration's thanks to the Members and leadership of this Committee for working with us on postal reform legislation and we look forward to continuing that productive dialogue going forward. The Administration also appreciates Postmaster General Jack Potter's strong leadership and hard work to drive change within the Postal Service, and we have enjoyed working closely with him and his staff.

I would like to begin my testimony by outlining the five principles of reform that the Administration has supported. These principles are as follows:

- Self-Financing - The Postal Service should be self-financed. This was the intent of the 1970 Postal Reorganization Act, but thus far it has never been accomplished. Today we are at a point, due in no small part to the Postal Civil Service Retirement System Funding Reform Act of 2003 (hereafter "the Postal CSRS Funding Reform Act"), P.L. 108-18, where we can ensure that the Postal Service covers all of its costs, including its massive unfunded liabilities, without potentially crippling effects on ratepayers.

- Transparency - The Postal Service should be a model of transparency. The past few years have highlighted the necessity for financial transparency in our nation's capital markets. We are all familiar with the limitations of the accounting standards that have been brought to light through the corporate accounting issues of the late 1990's and the collective responses from Congress, the Administration, regulators, and self-regulatory organizations over the past three years. While the Postal Service is a governmental entity, it operates as a monopoly. It has an enormous public trust and thus must not be exempt from the financial transparency requirements that we place on investor owned corporations. The public trust that the Postal Service holds demands a higher standard.

- Flexibility - The Postal Service should have the flexibility to operate as a business, including the ability to set prices, reduce costs, and adjust key aspects of its business in order to meet the challenges of a dynamic marketplace.

- Accountability - The Postal Service should be more accountable to all stakeholders. In order to protect ratepayers, mail recipients, taxpayers and universal mail service, there is a vital need for greater independent oversight given that the Postal Service is a monopoly that would be operating with greater commercial flexibility.

- Corporate Best Practices - The Postal Service should implement best practices of the corporate sector. This includes ensuring that the governing board is equipped to meet the responsibilities and objectives of an enterprise of its size and scope.

To more clearly outline the Administration's position in these areas, we provided a white paper in the 108th Congress listing a number of crucial long-term reforms. In this Congress, we took the further step of offering proposed legislative language to implement some of the more technical proposals. The Administration appreciates the Committee's willingness to address many of our concerns and include a number of our reform principles, and we look forward to working with you to further refine aspects of postal reform legislation consistent with these principles.

Reform must be Comprehensive

The Administration has always believed that reform must focus on the long-term health and viability of the Postal Service. There is an understandable temptation by some to tailor reform around the next rate case, but our horizon must be longer. Recognizing the importance of the Postal Service to our nation's citizens and commercial enterprises, the Administration is committed to ensuring the long-term financial and operational success of the Postal Service. We also recognize the systemic and structural challenges that the Postal Service faces in its business and believe that long-term reform will assist with both. The Postal Service faces an era of great change in which many believe that declining first-class volumes are unlikely to return. However, through reform and other initiatives collaboratively involving the Postal Service and mailers, it is entirely possible that new mail streams can be generated that provide a high value proposition to mailers. It is clear that the Postal Service must have a governing body, management team, and employees that are capable of recognizing the challenges and opportunities ahead with the insight, flexibility and skill to capitalize on them.

Flexibility

Pricing is a key part of the flexibility that the Administration believes the Postal Service needs. We support a hard rate cap, which provides that rates for any class of mail cannot rise more than the Consumer Price Index ("CPI") in any given year. The decision to support CPI as opposed to some other index was, in part, grounded on four factors:

1. the knowledge that overall postage rates have basically tracked CPI since 1972;

2. that productivity at the Postal Service has lagged the private sector by large margins since 1972 and therefore significant opportunities for a more productive Postal Service exists and this would enable it to operate within CPI;
3. to give the Postal Service stronger incentives to control its costs by discouraging it from simply passing costs on to ratepayers through a cost-based regulatory structure ; and
4. that wages generally rise faster than prices over time. This is largely due to increases in labor productivity. This difference in productivity allows firms to raise real wages without passing along costs to consumers through price increases. Generally, productivity improvements are expected to reduce prices.

We support the Committee's intent to establish a hard cap at CPI, and further support the Senate's version of an "escape clause," or exigency rate case, which establishes a very high bar to increase rates above CPI. This pricing flexibility will undo the current practice of irregular and lengthy rate cases that offer the Postal Service little managerial discretion and little or no predictability for the ratepayers.

We also seek to provide the Postal Service with flexibility on its cost side as well. We note that the Postal Service's $66 billion cost base provides significant opportunity for cost reductions without jeopardizing service quality or its universal service obligation. While some may dispute the absolute size of the potential reductions, it is indisputable that productivity at the Postal Service has lagged the private sector by large margins and that more effective management practices should be able to make significant progress in this area. One opportunity is in the underlying processing and distribution network and the potential to use this network in a more efficient manner.

Flexibility is not a blank check though. The Postal Service currently has the ability to negotiate its portion of the premiums for health and life insurance for its employees. The Postal Service has taken advantage of this ability and negotiated benefits beyond those offered by the U.S. Government. For instance, the Federal government pays 72 percent of an employee's health insurance premium while the Postal Service pays 85 percent of an employee's health insurance premium. Through this flexibility, the Postal Service has increased its costs by an additional $734 million. With respect to Basic life insurance, the Federal government pays 33 percent of an employee's Basic life insurance premium while the Postal Service pays 100 percent of an employee's Basic life insurance premium. Combined, the Postal Service has increased its costs for health and life insurance premiums by over $870 million annually above what the Federal government pays for most of its other employees.

We believe that it would be counter-productive to provide a list of specific cost reductions in statute, and instead have focused on a model where management has the flexibility to operate as a business within the constraints of a rate cap. This provides the right incentives for management without Congress or the Executive Branch micro-managing the business. In this way, the rate cap also drives greater board and management accountability, which is an important principle for the Administration.

Ensuring Self-Financing – Unfunded Liabilities

The Administration believes that comprehensive postal reform must require the Postal Service to cover all of its financial obligations, including its on and off-balance sheet unfunded liabilities. This is consistent with the statutory requirement that the Postal Service meet its responsibilities in a businesslike fashion by ensuring that revenues from the sale of products and services are sufficient to cover all operating costs. This concept of self-financing ensures that the Postal Service will operate in a manner that strengthens the financial and operational health of the Postal Service. It is important to recognize that since the 1970 Postal Reorganization Act, the Postal Service has never satisfied the statutory mandate of being fully self-financed. The Postal Service has accumulated approximately $75 billion of unfunded post-retirement health, pension and workers' compensation liabilities. Additionally, the Postal Service received approximately $27 billion of taxpayer funded appropriations since the 1970 Postal Reorganization Act.

While this may seem to paint a bleak picture of Postal finances, the Postal CSRS Funding Reform Act has provided a unique opportunity to substantially improve the financial health of the Postal Service. Specifically, the Administration has proposed to dedicate all the escrow created by the Postal CSRS Funding Reform Act to fund the unfunded post-retirement health obligations, which are approximately $64 billion. Without action, these unfunded liabilities grow to almost $100 billion in 2011, $208 billion in 2022, $422 billion in 2032 and over $1 trillion in 2045. We believe that the Postal Service should have a financing plan in place to ensure it can cover its post-retirement healthcare costs, and our proposal does that.

Some have said that the private sector does not pre-fund post-retirement health liabilities in the manner that we have proposed. We agree that the private sector generally has not fully pre-funded these liabilities, but note two important distinctions. First, in recent years, many firms that offer post-retirement health benefits have in fact established dedicated trusts to fund these liabilities as the seriousness of these obligations became apparent. More importantly, we recognize that the private sector has the ability to eliminate these, and other obligations either voluntarily or through a bankruptcy proceeding. These changes generally take the form of reduced or eliminated benefits.

We also recognize concerns from ratepayers over the 2006 rate case. The Postal Service has indicated that the need for the 2006 rate case is necessitated by the escrow established by the Postal CSRS Funding Reform Act and that without access to the escrow, rates must rise to compensate.

We believe that this analysis excludes the real reasons for the 2006 rate case. The reality is that any additional financial requirements of the Postal Service can be directly attributed to its inability to sufficiently reduce its costs since 2002, which is the date of the last rate increase. It is interesting to note that, if the Postal Service had the authority to raise rates under the CPI cap being proposed, the rates that would be in place today and in 2006 would be higher than what the Postal Service is currently proposing. While there are a lot of "puts" and "takes" in a business plan, I would like to address two components. Personnel will cost the Postal Service over $6.9 billion more in 2006 than it did in 2002 despite lower headcounts. This is based on actual results from 2002 and the Postal Service's projections included in its 2005 rate case filing. Fuel is also a significant component. We note that fuel costs for 2006 are projected to be over $700 million higher than in 2001, when the Postal Service filed its last completed rate case. The point of highlighting these two line items, which combined are well over two times the $3.1 billion rate increase that the Postal Service is asking for, is to demonstrate that the rate increase has its roots in the Postal Service's general cost structure and not linked to the escrow.

It is also important to realize that the Postal Service has already factored into rates, through the CSRS funding formula, the amounts that constitute the escrow, and therefore these amounts do not represent a "new" cost to be recovered. In other words, our reform proposal essentially replaces the "CSRS" expense line item with a new expense line item named "post-retirement health liabilities."

The Administration understands the concern over the 2006 rate case, but we also believe that all escrow funds should be committed to paying down unfunded liabilities rather than diverted in order to minimize a near-term rate increase. But the Administration does not view this as an either/or proposition, and we should consider exploring other alternatives to fully achieve both objectives. Before such alternatives can be considered, however, the Administration needs to see a clear path to enactment of postal reform legislation that includes the fundamental reforms that we have advocated.

Ensuring Self-Financing – Military Service

There has been a great deal of discussion about the Administration's position on the military service issue, and this hearing provides an opportunity to set the record straight. The decision in the Postal CSRS Funding Reform Act to allocate the $27 billion in retirement costs for the military service of the

Postal Service retirees was justified for many reasons which are being addressed by OPM's Acting Director Blair in his testimony.

In addition to the arguments that Acting Director Blair addresses in his testimony, I would also like to note that the allocation of military service retirement costs is fair and equitable because the Postal Service has been the beneficiary of significant taxpayer funded appropriations, which more than cover any perceived "unfair" attribution of the $27 billion of military retirement costs to the Postal Service. In addition to the $78 billion credited to the Postal Service through the Postal CSRS Funding Reform Act, the Postal Service has received approximately $27 billion in taxpayer-funded appropriations from the Federal government since enactment of the 1970 Postal Reorganization Act. If the goal is to revisit all of the assumptions that were the underpinnings of the 1970 Postal Reorganization Act and decades of Congressional decisions, it would be fair and equitable to revisit the appropriateness of the taxpayer-funded appropriations that the Postal Service has received. Using the same investment rates that OPM used in calculating the figure for CSRS over-funding, and based on the timing of these yearly Federal government transfers to the Postal Service, Treasury has calculated that the Postal Service would owe more than $200 billion to the Treasury for the use of the appropriations through FY 2003. We could elaborate on many other unique benefits the Postal Service accrues as a result of its special relationship with the Federal government, which include the ability to borrow up to $15 billion from the Department of the Treasury at below-market rates; exemption from federal income taxes, exemption from state and local taxation, and the power of eminent domain. So, during a period when the Postal Service has a statutory mandate to be self-financing, the Postal Service's cumulative performance has been bolstered enormously and in an extraordinary way by U.S. taxpayers, and as a direct benefit to ratepayers. I do not raise this point to call these transfers into question. However, I bring up this fact to further underscore the point that the Postal Service has benefited greatly during the past three decades, in an amount far exceeding the $27 billion currently under debate.

Transparency

The Administration believes that real financial and operational transparency is essential to postal reform. In the case of the Postal Service, the public interest and trust demands a very high level of transparency. We seek to obtain this enhanced transparency through SEC reporting standards and a robust, independent regulator. We are pleased that the Senate has seen fit to adopt many of the Administration's recommendations in this area.

Financial transparency is important for ratepayers, taxpayers, competitors, employees and management. The Administration believes that the Postal Service should be given great flexibility to set prices and to provide work-sharing discounts and enter into negotiated service agreements. While the Administration has dropped its requirement for audited product-line financial statements, we do believe that the Postal Service needs to develop and instill a culture that measures and understands its costs at a very fine level, which is consistent with the best practices in the private sector. While it is true that private sector companies generally do not issue product-line financial statements, they do in fact have them for internal purposes, which include performance measurement and the pricing of products, services and contracts. With the expanded flexibility that the Postal Service has on pricing, discounts and service agreements, the Postal Service needs to fully understand the true financial implications of its decisions.

In lieu of product-line financial statements, we have sought segment reporting which is consistent with SEC requirements. Given the uniqueness of the Postal Service, we have sought to define the segments. We believe that five segments represent a reasonable requirement based on today's business and would lead to segment reporting on First Class Mail, Standard Mail, Competitive Products, Periodicals, and Other. It is important to note that our language, while defining the segments, narrowed the reportable information by eliminating the SEC requirement to report "total assets." We did this because of recognition of the difficulty that this would pose for the Postal Service to establish what assets belong to which segments. Beyond the narrow issues that we have addressed, we are comfortable that the SEC's requirements and the exceptions that it provides for all registrants when items do not apply are sufficient for the Postal Service. It is unnecessary and unwise to allow the regulator to relax the SEC requirements.

Another aspect of financial transparency is the recognition of all of the Postal Service's liabilities, including those that are currently not on the balance sheet. The post-retirement health liability is the single largest liability excluded from the Postal Service's financial statements and the one that causes the most concern. This is because the Postal Service has excluded approximately $64 billion in costs from the rate base. We are also concerned by the Postal Service's acknowledgement that it has included the workers' compensation liabilities in its rate base yet it still has $7.6 billion of unfunded workers' compensation liabilities. The Postal Service has used funds that were part of its workers' compensation expense requirements in previous rate cases for non-workers' compensation related expenses.

The issue of what information is confidential and who determines whether it is confidential is an important issue of transparency. We fully understand that certain information of the Postal Service is confidential as is common in both the government and private sectors. We agree with the Senate's approach to this matter: to allow the regulator to be the final arbiter of what materials should be confidential rather than the regulated entity.

Accountability

Accountability will result in many ways through our reform efforts. A hard rate cap that has a strict escape mechanism will drive management accountability. A strong regulator will drive accountability, and real financial transparency will drive accountability.

We also believe that a revised compensation structure for senior management will help drive accountability. It is critical to provide flexibility to the Board of Governors to fairly compensate senior executives in a manner that will help attract and retain the very best. We all recognize that even with this flexibility, it is not possible to provide the same private sector compensation opportunities. But it is a step in the right direction as we demand a more private sector like focus on business operations, productivity and financial performance. In another accountability measure, we believe that the regulator should have a review role in the new compensation flexibility.

Conclusion

Congress now has a unique opportunity to take decisive action on a comprehensive postal reform bill that will set the Postal Service on the course to financial and operational stability. We believe that the five principles discussed will align the incentives, create a performance oriented culture, and ensure the proper accountability for the largest monopoly in the world. Thank you for the attention you are paying to this critical aspect of our country's economy. The Administration remains prepared to actively work with you to craft a comprehensive reform bill that will stand the test of time in an enormously dynamic market. We believe it critical that reform legislation result in a sharing of sacrifice with all stakeholders, and characterized by the five principles we have articulated.

Once again, I thank you for your kind invitation to appear today.

STATEMENT OF THE HONORABLE DAN G. BLAIR
ACTING DIRECTOR
OFFICE OF PERSONNEL MANAGEMENT

before the

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

on

REFORM OF THE UNITED STATES POSTAL SERVICE

APRIL 14, 2005

Madam Chairman and Members of the Committee:

I am pleased to be here today to discus the issue of reform of the United States Postal Service. This Administration regards enactment of comprehensive legislation to reform the United States Postal Service in a principled manner as an essential goal. We appreciate this opportunity to work with you towards a solution that will enable the Postal Service to respond not only to today's known needs, but also to unforeseen future issues, in a responsible manner that is fair to taxpayers, ratepayers, and Postal Service employees.

Assistant Secretary Bitsberger's testimony today clearly states the Administration's overall approach to this matter. Thus, to avoid redundancy, I will limit my statement today to important benefit issues where additional clarity would be useful.

POSTAL RETIREMENT FUNDING BACKGROUND

The Postal Service has been treated differently than other Federal entities for more than three decades when it comes to retirement payments. Not only did it have to make payments not required from other agencies, there was a period of time when the Postal Service was actually overfunding its obligations under the Civil Service Retirement System (CSRS). Enactment of Public Law 108-18, the Postal Civil Service Retirement System Funding Reform Act of 2003, cured that problem. Under current law, the Postal Service is paying its actual retirement costs.

In order to understand where we are, it is important to understand how we arrived here. When the Postal Service was established as an independent entity within the Executive Branch in 1971, the Congress made the policy decision that postal employees would continue under the same benefit programs available to Government employees generally, including CSRS.

At that time, the Postal Service and its employees made the same payments to the Retirement Fund that were required of other agencies and employees. However, in 1974, the Congress enacted the first of a number of laws that provided for additional postal payments to the Retirement Fund, with obligations retroactive to 1971. Public Law 93-349 required the Postal Service to fund retirement costs resulting from wage increases pursuant to negotiated agreements.

Postal retirement funding remained unchanged until 1989, when, in the first of a series of bills, the Congress required the Postal Service to pay for cost-of-living adjustments for its annuitants, enacting Public Law 101-239. In 1990, the Congress revisited the issue of postal funding, by requiring payments for employees who separated or died at any time after the Postal Service was created. Congress again amended the law in 1991 to require the Postal Service to make payments for pre-1991 cost-of-living adjustments to annuities. The final of the series of laws increasing postal payments was enacted in 1993 obligating the Postal Service to pay into the Fund a total of $693,000,000 through Fiscal Year 1998.

In 2002, the General Accounting Office (GAO) conducted a review of Postal Service finances. As a part of that review, GAO asked OPM to review the Postal Service's CSRS financing as if a separate retirement account had been established for income and benefit payments since 1971. We undertook that analysis, during which OPM actuaries projected that due to a number of factors, but primarily higher than expected yields on pension investments, future payments required under then-current legislation would have overfunded the Postal Service estimated CSRS liability by almost $78 billion.

Because of that potential overfunding, we developed the legislative proposal that was the basis of section 2 of Public Law 108-18. That provision reduced Postal Service payments to the Retirement Fund and ensured that the Postal Service meets its pension obligations for its current and retired CSRS employees.

MILITARY SERVICE

Madame Chairman, you will remember that I testified before you last year to explain why we oppose funding CSRS benefits relating to military service of Postal Service retirees from the Treasury. Today, I would like to reemphasize the Administration's strong objection to such funding, which would amount to a taxpayer subsidy of Postal operations.

Postal Service payment of $27 billion of the cost of military service for Postal retirees, as required under the Postal CSRS Funding Reform Act, is justified for many reasons. This obligation is fair and equitable because the Postal CSRS Funding Reform Act effectively converted the Postal Service's CSRS to the funding system utilized for the Federal Employee Retirement System (FERS), which requires each agency (rather than the Treasury) to cover the military service retirement costs of its retirees. The Postal CSRS Funding Reform reduced the Postal Service's pension obligations by $78 billion. In our view, the Postal Service should not benefit from the dynamic valuation of its pension fund without assuming responsibilities that come with dynamic funding.[1] To do otherwise would mean that we endorse selectively implementing portions of dynamic funding, thus creating a hybrid that has both CSRS and FERS-like qualities. We do not support this approach.

The military service credit is a component of the government's overall benefits package. The government, as well as private sector employers, offers a variety of benefits tailored to meet their individual recruitment and retention needs.

The Federal government's retirement benefit, which includes the military service credit, is a valuable component of the government's overall compensation package. Since the Postal Service uses and receives the benefits of this human capital tool in the form of recruitment and retention of its own employees, it should pay for its full cost. There is no basis for the taxpayers to subsidize any element of the Postal Service's compensation package.

The value of this benefit was demonstrated by our recently completed 2004 OPM Benefits Survey. We are completing our final analysis of the results of that survey in which we queried over 2400 new hires and tenured employees throughout Government. Our preliminary analysis of the submissions by the nearly 900 respondents indicates that they consider our retirement package to be the employee benefit that is most important to them.

The law requires the Postal Service to manage its finances to ensure that its revenues cover its costs, unlike virtually all other Federal agencies. The parallels between departments such as Defense, Education, Housing and Urban Development, Health and Human Services, Treasury, Homeland Security, Justice, et al, and the Postal Service simply do not exist. For other agencies, the cost of the military service credit under the CSRS is borne by taxpayers regardless of whether they are charged to the General Fund of the Treasury or charged to agency budgets. By contrast, Postal Service costs are paid through postage revenues rather than funded by the Treasury.

I would also point out that last year, Congress enacted legislation according similar pension treatment to the Patent and Trademark Office ("PTO"). Pursuant to that legislation, PTO, which is also a self-funded agency, is required to pay the full costs of CSRS benefits, including those associated with military service. The President's 2006 budget proposes this practice be continued at the PTO.

Some small entities have also been required to pay the full costs of CSRS benefits, which include the military service credit, on a prospective basis. At the time these organizations were carved out of the Federal Government, their Federal employees' retirement coverage was "grandfathered" under the condition that the full cost was paid.

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[1] Under "static" funding assumptions, computations are not made under real world conditions, because it is assumed that inflation and pay increases do not occur, and the interest rate assumption is thus also set lower than actual expectations. Under "dynamic" funding assumptions, computations yield results that are consistent with actual expectations, because the best possible estimates are included with regard to inflation, pay increases, and interest rates.

When the Metropolitan Washington Airports Authority ("MWAA") was created by Public Law 99-500 in 1987, former Department of Transportation employees were permitted to retain their Federal retirement benefits. At that time, MWAA was required to prepay the difference between employer and employee contributions, and the actual cost of CSRS benefits, which included the military service credit.

In 1996, Public Law 104-134 spun-off the United States Enrichment Corporation ("USEC") from the Department of Energy as a private entity, and former Department of Energy employees were permitted to retain their Federal retirement benefits. For its CSRS employees, USEC, like the Postal Service, is required to pay the dynamic normal cost[2] less employee deductions, which includes the cost of military service credit.

While these are small organizations, we regard their situations as being analogous to that of the Postal Service. In each case, there was a mandate that full retirement costs be paid by the entity. And in each case, the cost of service credit for military service was included in the payments required to be made.

In addition, past Presidents' Budgets have proposed to change CSRS funding for all agencies by requiring payment of the full costs of CSRS. I would emphasize that full funding of CSRS is not a partisan issue, and that both this and a prior administration did in fact submit proposals to the Congress that would have required service in a manner similar to that under FERS.[3] Under these proposals, agencies would pay the costs of military service in their accrued liability payments. The appropriate, "good-government" response to the under-funding issue is to require all agencies to pay the full cost of CSRS, not to give the Postal Service a discount from the real cost.

Finally, I note that the taxpayers already fund approximately $21 billion in military service retirement credits under the current CSRS methodology for Postal funding. The $21 billion that the taxpayer has paid is the CSRS military service cost attributable to pre-1971 civilian Post Office employment for Postal retirees who retired after 1971. In other words, this represents the pro-rata share of the cost that is allocated to Treasury based on the portion of the retiree's civilian service that was performed before 1971. Thus, even though a Postal Service employee retires under the Postal Service, Treasury will continue to assume a portion of the retirement cost for military service if the retiree had some civilian service under the old Post Office Department. This is fair, because the obligation was created prior to the existence of the Postal Service.

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[2]While the technical definition is more detailed and complex, in essence the "normal cost percentage" is the percentage of salary that must be contributed at the time service is performed in order to pay the full cost of retirement benefits, assuming that the contributions begin at first creditable employment, and that the system will continue. The normal cost percentages change from time to time based upon changes in the underlying economic assumptions. To fully fund the retirement system, the normal cost percentage of basic pay must be paid into the Retirement Fund at the time service is performed.

[3]The "Federal Retirement Accrual Accounting Amendments of 1995" was submitted in the 104th Congress, and the "Managerial Flexibility Act of 2001" in the 107th Congress.

However, shifting further liabilities - that essentially fund Postal operations–to the taxpayer would be wrong.

In our view, CSRS military service credit associated with post-1971 Postal Service civilian employment should be accorded and funded in the same manner as other employee benefits. If we are to honestly maintain the policy that the Postal Service is to be financially self-sufficient, then the Postal Service must bear the cost of that benefit. Any transfer of those costs to the Treasury would constitute a taxpayer subsidy of postal operations and would violate the principle that the Postal Service should be self-funding.

PRE-FUNDING RETIREE HEALTH BENEFIT COSTS

The Administration supports the principle of prefunding health insurance and pensions. The Managerial Flexibility Act of 2001 introduced in the 107th Congress would have implemented this requirement for CSRS for all agencies, and would have also required all agencies to prefund their employees' retiree health benefits. Since 1987, all agencies have been required to prefund the full cost of their pension liabilities under FERS, which covers over 70 percent of current employees. Since 1997 all agencies have been required to recognize the accruing costs for both CSRS and post retirement health insurance liabilities on their annual financial statements. As a result of the 2003 Postal Pension Reform Act, the Postal Service is now required to prefund its CSRS pension costs, putting USPS closer to the true intent of the 1971 postal reorganization - - that the cost of postal operations be borne by the users of postal services.

However, Postal retiree health benefits are currently funded on a pay-as-you-go basis. That is to say, the Postal Service pays its portion of the Government share of retiree health insurance premiums on the same monthly basis as the retirees. However, the obligation for these future payments actually accrues when employees are actively serving. Thus, there is a substantial unfunded liability that has accrued because no money has been set aside when service is performed for this future obligation. We believe that responsible financing requires that this obligation be recognized and funded when it is created. Thus, the law should provide for funding of the accruing cost for active employees plus funding of the liability accrued to date.

We believe the Postal Service's health liability should be funded over forty years with limited Postal liability for ten years. This would cap the total Postal Service liability during the first ten years to the amount of the escrow plus the health premium payments the Postal Service would be obligated to make under current statute. Thereafter, the additional Postal liability is manageable. We believe that this provides the Postal Service with an appropriate transition period to reduce its cost structure and to plan for the inclusion of these additional liabilities.

S. 662

Madame Chairman, I would like to add a few comments on the benefit aspects of S. 662. Section 802 of the bill would transfer responsibility for the cost of CSRS military service credit from the Postal Service to the Treasury, resulting in a $27 billion benefit to the Postal Service.

The Postal Service would no longer have to make CSRS retirement contributions based upon a percentage of salary paid to employees. This amount would be transferred to reduce the unfunded liability for annuitant health benefit costs. Using these funds for that purpose is preferable to giving it directly to the Postal Service; however, we strongly object to the underlying proposal to shift liability for this benefit from the Postal Service.

Section 803 of the bill would establish a new Postal Service Retiree Health Benefit Fund, administered by OPM, and invested in the same manner as the Retirement Fund. Future payments for the employer share of health benefits premiums for retired Postal employees will be made from the Fund.

In addition to the transfer payment from the Retirement Fund required by section 802, the new Fund will receive two forms of payment from the Postal Service. Under section 803, OPM will calculate the net present value of the unfunded liability for future payments required for the Government share of health benefits premiums for retired Postal employees. The Postal Service will make annual payments into the new Fund to amortize that unfunded liability over a period of 40 years. In addition, the Postal Service will pay the present value of the future Government share of the premium payments for Postal retiree health benefits attributable to the service of Postal Service employees during the current fiscal year.

We believe that the retiree health benefits funding mechanism provided for by S. 662 is a responsible plan, but for the provisions for the transfer from the Retirement Fund. We would support the full-funding concepts contained in section 803, provided that section 802 is deleted from the bill.

CONCLUSION

The Administration recognizes that we stand at a critical juncture in the history of how postal services will continue to be provided to this Nation. We are in agreement that the 35 year old legislative framework governing the Postal Service is in grave need of reform. But in moving forward, we must not violate bedrock principles such as self financing. Shifting retirement liabilities from the Postal Service, where they now properly rest, to the taxpayer runs counter to true reform. We deeply appreciate the opportunity to work with you in efforts to craft legislation that the Administration can endorse and support.

In conclusion, Madam Chairman, thank you for including me in today's panel. I will be glad to answer any questions you may have.

TESTIMONY OF
JOHN E. POTTER, POSTMASTER GENERAL/CEO,
BEFORE A HEARING OF THE
COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
APRIL 14, 2005

Good afternoon, Chairman Collins and Committee members. I am pleased to be with you today as we continue the critical discussion about the need for comprehensive reform of the legislative framework governing the Postal Service.

We appreciate the Committee's leadership in hearing from a broad range of postal stakeholders as part of its work in attempting to develop reform legislation that protects universal service – our ability to provide quality, affordable, accessible mail service to every household and business in America.

That has been, and continues to be, the role of the United States Postal Service. And we are proud of that role. We are, perhaps, the most tangible daily link between the people of America and their government. Yet we are profoundly different from other government agencies. That's because postal operations are funded by the sale of postal products and services – not by tax dollars. In fact, the Postal Service is self supporting and has not received a public service appropriation since 1982, saving American taxpayers more than $11 billion, the amount authorized by law.

This has not always been the case. Until today's Postal Service was created in 1971, 18 percent of the annual costs of operating the former Post Office Department were paid by direct appropriations – tax dollars. A self-supporting Postal Service – one that has broken even over its 34-year history – is among the significant legacies of the landmark 1970 legislation that created today's Postal Service.

Our presence here today is a strong affirmation that we do not want to return to the days when America's mail system was dependent on an annual infusion of tax dollars to make ends meet. Yet, when I became Postmaster General in June 2001, that possibility – previously unthinkable – was not as implausible as it once seemed.

Just a few months earlier, the Government Accountability Office placed the Postal Service on its "High Risk List." The GAO cited a growing risk of our not being able to continue providing universal postal service, vital to the national economy, at reasonable rates, while remaining self supporting through postal revenues.

In a later Senate hearing on this subject, Comptroller General David M. Walker pointed out that only the Postal Service's governmental status provides insulation from the bankruptcy process that would be applicable to private sector companies in a similar situation.

Like Mr. Walker, our Board of Governors and Postal Service management recognize the difficult, long-term challenges facing the organization. We will be examining them in some depth today. We will be examining the considerable progress we have made in responding to those challenges through our Transformation Plan. We will also be examining the fundamental problems of our governing statute that are central to the GAO's "High Risk" designation.

To be fair, the Postal Reorganization Act of 1970 could not anticipate the development and widespread adoption of electronic communications or their effect on mail volume. The Act could not foresee the robust growth of a highly competitive private-sector delivery market, one that includes affiliates of foreign postal administrations. While the Act set the stage for three decades of success in serving America, it was the product of another time. As such, it also imposed the limitations that are at the heart of the situation we face today.

When we were placed on the "High Risk List," the challenges were formidable. Mail volume was declining. From a high of almost 208 billion pieces in 2000, total volume fell by more than four billion pieces the following year. More significantly, we were starting to see volume erosion in high-margin First-Class Mail. By 2002, First-Class volume was down 1.2 billion pieces from the previous year.

Mail volume, to some extent, is a bellwether of broader economic trends. The declines we were experiencing certainly reflected a soft economy as well as the negative business effects of the terrorist attacks of the fall of 2001. However, it was also clear that the long-predicted electronic diversion was beginning.

At the same time, expenses were rising. Our delivery network – and its associated costs – continued to grow by about 1.8 million new addresses each year. In a standard business environment, yearly acquisition of this number of new customers would appear to be a growth opportunity. For the Postal Service, this is not the case. In an environment of declining, high-contribution First-Class Mail volume and expanding deliveries, this trend will continue. Simply put, we are delivering fewer pieces of mail to more addresses, placing severe pressure on our bottom line.

With expenses outpacing revenue, we experienced three consecutive years of net losses through 2002. Over that period, cumulative losses reached $2.6 billion.

Declining revenues required the maintenance of a strict freeze on capital spending for most facility projects. Capital commitments, which stood at $3.6 billion in 2000, were reduced to $1.9 billion by 2001, affecting the maintenance and modernization of our infrastructure of more than 37,000 postal facilities. However, we continued to invest in necessary life-safety systems and we invested in mail processing equipment and other projects that provided a positive return on investment.

By 2001, our debt had reached $11.3 billion, an increase of almost $2 billion from the previous year, and only $3.7 billion below our statutory debt limit. Servicing that debt resulted in costs of more than $300 million in 2001.

And, as estimated by the Government Accountability Office, the Postal Service's major liabilities and obligations were close to $100 billion. That included liabilities for annuities, workers' compensation benefits, debt, and other obligations for post-retirement benefits.

As we took stock of our financial situation, it was clear that we had to go beyond "business as usual." Our ability to continue successfully serving the nation would be dependent on our willingness and ability to transform and bring a new sense of urgency, focus and innovation to everything we did.

It was equally clear that our business model, established by the same 1970 law that created the Postal Service, was inadequate for the needs of today. Its assumption, that continually rising First-Class Mail volume would produce the revenue necessary to support a continually growing delivery network, was no longer valid.

When I became Postmaster General, there was broad consensus that structural reform of the laws governing the operation of the Postal Service was necessary. Indeed, Congress had taken some encouraging steps in that direction.

At the same time, we recognized the obligation of the Postal Service to push business effectiveness and operational efficiency to the limits permitted by current postal laws. We were encouraged in this direction by Congress and by the Government Accountability Office.

The result was our comprehensive Transformation Plan. With wide-ranging stakeholder input, we created the Plan to help us meet the challenges of long-term technological and commercial trends that are fundamentally reshaping the postal landscape here and throughout the world.

As the process of legislative reform continues, the Postal Service understands that it cannot relax its efforts. We must continually work to offer better value than ever. We must continue to offer a favorable return on our customers' investment. We must continue to offer ease of use. We must continue to offer the solutions our customers need. Above all, we must have the ability to offer attractive and affordable rates. This is why one of our key transformation strategies is fostering growth by continuing to increase the value of postal products and services to our customer.

To do that, we have challenged our managers to "think outside the box." And they have come through. They responded with creative approaches to pricing and to products. Across the entire organization – in every functional area – our people understood the need for change. They made implementation of our Transformation Plan their focus, and they delivered results.

Perhaps the best example is Negotiated Service Agreements, which provide pricing incentives for mailers to encourage more First-Class Mail volume, while reducing handling costs for the Postal Service. In just a single year, the first of these agreements produced a combination of $21.7 million in cost reductions and increased contribution from higher mail volume. To date, three financial service mailers have worked with us to develop Negotiated Service Agreements. Approval of a fourth NSA is pending with the Postal Rate Commission.

For consumers, we have filed an experimental rate case for Premium Forwarding Service, bringing a new level of convenience for customers who temporarily relocate. For a flat fee, all mail – including that not normally forwarded – is bundled and sent by Priority Mail to the customer's temporary address.

We have added flexibility to mail design and envelope preparation, providing mailers with creative opportunities to have their messages stand out with their customers. We have simplified package mailing by offering flat-rate and prepaid Priority Mail products. We have shared the results of research by the leading internet audience measurement service demonstrating that catalogs and direct mail can increase internet sales. We have established partnerships that place Postal Service shipping solutions on popular web sites. We have also taken advantage of advanced technologies to provide mailers with ready access to information about the status of their mail as it moves through our processing system.

In today's competitive environment, ease-of-use must be at the center of everything we do. This philosophy was behind the first comprehensive reorganization of our mailing standards in more than a decade, making it easier for customers to locate – and understand – the standards that apply to any type of mailing.

Similarly, we have consolidated our four field rates and classification service offices into a single Pricing and Classification Service Center. This expands the range of services offered to business mailers and enhances the timeliness, quality and consistency of decisions affecting mail classification. And, at the point of mailing, electronic systems are linking customer mailing information with Postal Service acceptance, verification and payment systems, streamlining business mail entry.

While our vast network of facilities has expanded over time to meet the needs of an ever-growing nation, we recognize that there are more cost-effective ways to bring the Post Office to our customer than constructing new buildings. The same technologies that provide today's consumers with new ways to communicate also provide them with new ways to take advantage of our products and services.

Our website, usps.com, always a valuable source of mailing information, now offers quick, easy and convenient access to a broad range of products, services and features. Through usps.com, customers can buy stamps, pay postage, print mailing labels, select insurance, add delivery or signature confirmation, track delivery status, and arrange for carrier pickup of their prepaid packages.

We are bringing modern technology to our retail units as well. In the last year, we have installed more than 2,500 Automated Postal Centers in centrally located Post Offices throughout the nation. These popular, self-service kiosks, which offer 80 percent of retail services, make a visit to the Post Office quicker and more convenient because many are available around the clock, better meeting the needs of today's busy consumer.

We will continue to encourage innovation in pursuit of revenue growth. This is every employee's responsibility and it is a message we are communicating at every level and to every employee of the organization.

Of course, if we are to provide value to mailers, the products and services we offer must be supported by operational excellence and an intense focus on efficiency and cost management.

Over the last several years, we have extended the benefits of automation from letter mail to larger, flat-size pieces. And we are deploying a new Automated Package Processing System, which brings increased sorting efficiency, speed and accuracy to bundle and package handling. This will contribute to better service and reduced costs. Through advanced automation, we have also developed a more effective way to speed the delivery and reduce the expense of forwarding mail to customers who have moved.

Our Breakthrough Productivity Initiative, begun in 1999, continues to drive system standardization, improving efficiency and reducing costs. We recognize that in an organization the size of the Postal Service, no single group holds a monopoly on innovation. One of the greatest benefits of this initiative has been its success in identifying operational best practices, recognizing those who have developed them, and applying them broadly throughout processing plants and Post Offices from coast to coast.

We have also improved the efficiency and effectiveness of administrative systems and processes, from purchasing and accounting to information technology and human resources. We are serving our internal customers better, providing them with the information and services they need, and reducing costs as we do it.

At the heart of all of our efforts is our career workforce – the 700,000 men and women of the Postal Service. Some you know – your letter carrier, your postmaster, or the clerk at your local Post Office. Some you may not have met – our drivers, mechanics, custodians, supervisors, and the clerks and mailhandlers who keep our processing facilities operating around the clock.

We have been focused on improving their workplace environment, understanding that cooperative and collaborative working relationships will allow us to bring greater focus to meeting the needs of our customers. And the workplace is improving. Our unions have been instrumental in helping us find better ways to resolve workplace disputes and implement new programs to improve safety. Over the last three years, we have experienced a 61 percent reduction in grievances pending arbitration. Employees are safer, too, with a 36 percent decline in work-related illnesses and injuries.

We continue to make diversity a hallmark of our organization – and others are noticing. For the fourth straight year, Fortune magazine has named the Postal Service one of the "50 Best Companies for Minorities." A diverse workforce, by bringing us the experience and perspective that reflects the energy of the communities we serve, provides an important edge that supports our success. Our focus also includes efforts to recruit, develop and retain a diverse group of executives.

Our Human Capital initiatives place an emphasis on planning for the future. Leadership development is absolutely critical to the Postal Service as greater numbers of our supervisors, postmasters, managers, executives and officers near a time when they can consider retirement. A critical component of these efforts is our new Succession Planning process, an important tool in identifying and developing a pool of qualified candidates for executive positions. And our executives' responsibilities include working with staff to create individual development plans to help prepare them for positions of greater responsibility and realize their full leadership potential.

A significant innovation in our Human Capital activities is the Executive Development Program. We recognize that it is not enough simply to prepare our people to assume executive responsibilities. We must also support our executives with new managerial tools, fresh perspectives and shared experiences they might not normally encounter through their regular duties.

And, for our supervisory and managerial employees, we have introduced a new pay-for-performance system. Their compensation is now directly linked to the achievement of specific performance goals.

We are transforming the Postal Service. We are doing everything within our power to add value for our customers, improve operational efficiency, and enhance a performance-based culture.

How far have we come in three years? The results have been impressive.

Last year, through the outstanding efforts of our employees – and validated by independent measurement systems – we delivered record levels of service performance and customer satisfaction. For the second straight year, 95 percent of First-Class Mail for delivery to next-day service areas arrived on time. In fact, service in all measured categories is at record levels, contributing to a customer satisfaction rating of 94 percent.

Our success goes beyond service excellence. It includes a cumulative $8.8 billion reduction in costs since 2001. It includes a reduction of our debt by $9.5 billion, to $1.8 billion at the close of 2004. It includes a fifth straight year of positive total-factor productivity, the equivalent of $6.1 billion in cost savings. It includes bringing our staffing to pre-1985 levels, despite mail volume growth of 75 billion pieces and delivery point growth of 33 million addresses. It includes two consecutive years of positive net income, totaling $6.9 billion. And it includes the fact that, over the last 34 years the Postal Service has recovered all prior years' losses, meeting its statutory "break even" mandate. From 1972 through 2004, we have generated revenue of $1,246,200,000,000 sufficient to more than cover our costs of $1,245,300,000,000 during this period.

For our customers, one of the most significant – and visible – benefits of our transformation efforts has been steady rates. The price of postage has not changed since 2002 and will not change before 2006, a span of almost four years.

While the Postal Service has recently filed a rate case with the Postal Rate Commission, this is not a function of revenue failing to meet operational costs. We expect to end this year in the black, with positive net income exceeding $1 billion.

The Postal Service must seek a rate increase now to comply with the requirements of Public Law 108-18, the Postal Civil Service Retirement System Funding Reform Act of 2003. In adjusting our payments to help the Postal Service avoid overfunding this employee retirement program, the Act also requires that we pay $3.1 billion – the so-called "savings" between our former, higher payment rate and the current, lower rate – to an escrow fund beginning in 2006. This escalating escrow payment requirement will have a continuing and increasing effect on our finances, peaking at $7 billion in 2024.

In 2003, 2004 and 2005, the "savings" were used to help reduce debt, offset operational expenses and hold postage rates steady. If the escrow requirement did not exist, we could hold rates steady until 2007. Should legislation be enacted that eliminates the escrow funding requirement, this rate case will be withdrawn.

The future of America's postal system, however, will depend on much more than the next rate case. It will depend on a series of critical actions and decisions – by the Postal Service, by the Congress and by the Administration.

As an organization, the Postal Service will stay focused on transformation. We will not step back from our pledge to ensure the continuation of affordable, universal service. We will not waver from our path of reducing costs and increasing efficiency to create value for our customers. To this end, last month at the National Postal Forum, we began gathering stakeholder input to assist us in updating the Transformation Plan to carry us through 2010.

Yet, we recognize that there will come a time when the efforts of the Postal Service alone will not be enough. Declining First-Class Mail volume, coupled with a market shift from higher-margin to lower-margin products, will result in insufficient revenue to support our infrastructure and the costs of an ever-expanding delivery network. We will reach a point when our ability to continue reducing costs reaches its limits. At that point, our options will be limited, and those options, by their very nature, will simply exacerbate the crisis.

One option is relying on rate increases to make up any financial shortfall. But, as electronic diversion continues to erode First-Class Mail volume, this product will become more price-sensitive than ever. Higher rates will likely increase the pace of change, accelerating the volume decline, resulting in falling revenue and the need, again, to increase rates. It is an economic model that is not sustainable in the long term and could lead to the proverbial death spiral that many have predicted.

A second option is to achieve continued savings by reducing basic service. This, too, would likely drive customers to embrace alternatives to the services we provide, contributing, again, to mail volume decline. At that point, we would face the same, inevitable revenue pressure that would create a fatal, upward price spiral.

As Comptroller General Walker told this Committee late in 2003, "since we placed the Service on our high-risk list in April 2001, the Service has developed its 2002 transformation plan, cut various costs, and improved its productivity. These are all positive, important steps which Postmaster General Potter ought to be commended for." But he also cautioned that, "modest incremental steps cannot resolve the fundamental and systemic issues associated with the Postal Service's current business model." Mr. Walker on that, and other occasions, has urged Congress to enact comprehensive postal reform legislation.

The President's Commission on the U.S. Postal Service reached a virtually identical conclusion following its exhaustive study of the pressures faced by America's postal system. As the Commission so succinctly put it, "Fundamental change is the only option that will deliver a high-quality, financially stable Postal Service."

It is clear that we are closer to achieving comprehensive reform of the laws governing the Postal Service than at any time since today's self-sufficient Postal Service was created more than three decades ago.

The Postal Service is a system of amazing complexity. Its successful operation is based on the proper ration of finely-tuned interdependencies that allow it to meet its obligations to the nation. If a single element of that equation moves out of alignment, it can have a profound effect on the entire system.

We strongly believe that successful reform legislation will have to achieve the right balance in three basic areas: postal costs, postage rates, and service levels. If the Postal Service does not have the ability to control costs, postage rates will go up or service levels will fall. There are no other options. With that in mind, it is imperative that I reiterate a number of elements identified by the Governors of the Postal Service as essential to postal reform.

The escrow requirement established by Public Law 108-18 should be eliminated and the military service retirement payment obligation returned to the Department of the Treasury. In its place, we support the creation of a payment stream to prefund retiree health benefits. The Postal Accountability and Enhancement Act, S. 662, addresses both of these concerns. It creates a 40-year amortization payment schedule for these obligations. This level payment stream will be particularly important in a rate-cap environment. By returning this obligation to the Treasury, S. 662 creates a deposit in the retiree health benefit trust fund of $17 billion, which holds down the payments needed to amortize the retiree health benefits funding.

The portion of the costs of Civil Service Retirement System benefits for Postal Service employees attributable to their military service should not be borne by the Postal Service. The requirement that military service count toward a Postal Service employee's annuity is federal policy and a national obligation. In addition, the Postal Service is required by law to give preference to veterans when hiring new employees. While we support veterans' preference, shifting responsibility for military service from taxpayers to ratepayers is unfair. If this requirement is not removed, the Postal Service will be the only federal agency with employees covered by the Civil Service Retirement System that is required to fund these benefits.

We believe that reform legislation should incorporate changes in the area of labor, which accounts for almost 80 percent of our costs. Without any changes in labor and an unaltered escrow payment – and coupled with a declining volume and a growing delivery infrastructure – operation within a rate cap that reflects the Consumer Price Index becomes nearly impossible.

The Postal Service is a strong supporter of collective bargaining. It has helped to maintain a healthy balance between the needs of Postal Service customers and the needs of our employees. Current law requires the Postal Service and its unions to address wage issues through collective bargaining.

The same law also imposes major federal benefit programs for employees by statutory requirement – not through the collective-bargaining process. As a result, a significant portion – some 20 percent – of our total compensation costs are exempt from collective bargaining. This represents the largest category of costs over which we have no control. For this reason, we believe that comprehensive reform legislation should include the ability of the parties to fully negotiate employer-employee contributions to the Civil Service Retirement System, the Federal Employees Retirement System, the Thrift Savings Plan, and the Federal Employees' Health Benefits program.

As part of the collective-bargaining process, we remain committed to good-faith negotiations. Over the past several years, the Postal Service and its unions have been successful in negotiating agreements without the need for third-party arbitration.

Yet, based on our experience, and despite the best efforts of the Postal Service and our unions, we know there may be times when the parties may fail to achieve a negotiated agreement. When that occurs, the law requires mandatory arbitration. We believe that an arbitrator should be required by statute to factor into an award the economic history of the employer, its present financial health and ability to pay, as well as anticipated future growth, productivity, and total labor costs.

Reform bills introduced in this Congress propose expanding the role of a new regulatory body beyond that of the current Postal Rate Commission. We are strongly opposed to expanding that role to include the power to determine the range within which the Postal Service and its unions may negotiate wages. This could have a chilling effect on collective-bargaining and unnecessarily impede the parties' ability to achieve a negotiated agreement.

Besides flexibility in collective bargaining, we strongly believe we should be granted more rate flexibility and authority to introduce new postal services.

Today's ratemaking process is both costly and time consuming. General rate cases take at least 18 months to conclude and, by the time new rates are implemented, the market may have changed significantly. Consequently, we believe that the Postal Service should be granted the authority to change rates and introduce appropriate new postal services – both with Board approval and within a price range determined by the regulator – without prior approval.

As we have seen in recent years, our finances can be affected dramatically by developments outside our control, such as increases in fuel costs or an economic downturn. With more than 37,000 facilities and a fleet of more than 200,000 vehicles, this can add significantly to our costs.

Historically, postage rates have stayed within increases in the Consumer Price Index. Therefore, if the Postal Service had the authority to adjust rates within a predetermined range, we believe that the CPI could serve as an acceptable – though extremely challenging – price cap. Over 34 years, we have been able to keep postage rates within the Consumer Price Index. Our ability to do this in the future is severely challenged as we face declining volume and revenue and growth in delivery points. The issue of cost attribution becomes vital in a rate cap environment, as attributable cost becomes the floor for postage rates.

It is imperative that a reasonable exigency provision be included, particularly in a bill providing for a rate cap tied to the Consumer Price Index. Given the pressure of prefunding retiree health benefits, the funding of statutory benefits for current employees and other cost pressures, a "reasonable and necessary" standard is essential. H.R. 22, the Postal Accountability and Enhancement Act, pairs CPI with such an exigency.

It is extremely important that the current practice of cost causality be retained for attributing costs, rather than by economic theories which do not relate directly to the product and that obscure its true cost. We believe the cap should be applied at the aggregate level, and certainly no lower than each class of mail, to allow the Board to exercise the requisite pricing flexibility.

Any future changes in the scope of the postal monopoly should be considered within the context of the Postal Service's universal service mission and other social policy obligations. We believe that Congress, not the regulator, is best positioned to set national policy and strike the proper balance among these dimensions.

In some areas, we are requesting more authority. We recognize that with this expanded authority comes added responsibility, including oversight by Congress and the Administration. We believe this represents an appropriate response to protecting the public interest.

The primary emphasis of the Postal Service has always been service. That will not change. As stewards of this public trust, we recognize and accept the challenge of managing our national infrastructure of facilities and transportation in a cost-effective manner that does not sacrifice service. We also understand that we must continue to develop new products and services – as we enhance those already available – to meet the changing needs of our customers in a new century.

With a balanced approach, the Postal Service can continue to build on its accomplishments and serve the nation for many years to come. In achieving that balance in reform legislation, we must confront difficult and sensitive issues involving pricing, labor and service. We believe this is necessary if we are to achieve the ultimate, long-term benefits that can grow from reform.

We cannot lose sight of the big picture. We cannot address any one of these elements without the others. If we are to set rates – and operate successfully – within the limits of a price cap tied to the Consumer Price Index, we must have the means of managing costs that our outside of our control today – costs that continue their steady upward growth. In practice, we believe this can be accomplished through the ability to negotiate employee benefits. Without an appropriate check on cost inflation, a rate cap would place pressure on our ability to continue delivering outstanding service, affordably, to every home and business in America.

On behalf of the Postal Service, I commend this Committee for its work. The issue of postal legislative reform is complex. There has been no shortage of strongly held positions about the shape it should take. You have taken the time to listen to the many voices involved in this important conversation. You have taken the time to understand what is at stake.

We recognize that legislation of this magnitude must incorporate a wide range of interests and concerns. When all is said and done, however, the litmus test of postal management and the Board of Governors comes down to one, simple question, "Do the current reform bills make it more likely that we will be able to protect quality, universal mail service at affordable prices, for everyone in America?" As the Chairman of our Board, James C. Miller III explained to the mailing industry last month, "If not, we are better off with no bill at all."

We look forward to working cooperatively with you in pursuing an affirmative response to that critical question.

Thank you.

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United States Government Accountability Office

GAO

Testimony
Before the Committee on Homeland Security and Governmental Affairs, U.S. Senate

For Release on Delivery
Expected at 2:00 p.m. EDT
Thursday, April 14, 2005

U.S. POSTAL SERVICE

Despite Recent Progress, Postal Reform Legislation Is Still Needed

Statement of David M. Walker
Comptroller General of the United States

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GAO-05-453T

April 14, 2005

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Highlights

Highlights of GAO-05-453T, a testimony before the Senate Committee on Homeland Security and Governmental Affairs

U.S. POSTAL SERVICE

Despite Recent Progress, Postal Reform Legislation Is Still Needed

Why GAO Did This Study

Both the Presidential Commission on the U.S. Postal Service (the Service) and GAO's past work have reported that universal postal service is at risk and that comprehensive postal reform legislation is needed to minimize the risk of a significant taxpayer bailout or dramatic postal rate increases. In April 2001, GAO added the Service's transformation efforts and long-term outlook to its High-Risk List. GAO has testified that comprehensive postal reform legislation is needed to clarify the Service's mission and role; enhance governance, transparency, and accountability; improve regulation of postal rates and oversight; help to ensure the rationalization of the Service's infrastructure and workforce; and make certain human capital reforms.

The Service has made significant progress on some of its key challenges but postal reform legislation continues to be needed in order to facilitate a broader transformation effort.
To help Congress and other stakeholders understand Service progress and the need for postal reform, GAO will focus on (1) Service progress since GAO put Service transformation efforts and long-term outlook on GAO's High-Risk List, (2) why comprehensive postal reform legislation is needed, and (3) key areas for comprehensive postal reform. This testimony is based on an update of GAO's statement to the Committee last year.

www.gao.gov/cgi-bin/getrpt?GAO-05-453T.

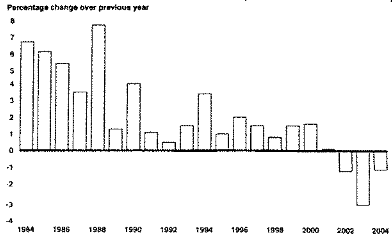
To view the full product click on the link above. For more information, contact Katherine Siggerud at (202) 512-2834 or siggerudk@gao.gov.

What GAO Found

The Postal Service has made significant progress since its transformation efforts and long-term outlook were added to GAO's High-Risk List in 2001, including achieving record net income, repaying most debt, increasing productivity, and downsizing the postal workforce. However, the Service's financial progress was largely due to a transitory boost provided by 2003 pension reform legislation that reduced the Service's pension costs in fiscal years 2003 through 2005, but also benefited from increased Standard Mail volume and revenues, and certain cost-cutting and efficiency initiatives.

Despite this progress, comprehensive postal reform legislation is needed to address the continuing financial, operational, governance, and human capital challenges that threaten the Service's long-term ability to provide high-quality, universal postal service at affordable rates. The Service's core business of First-Class Mail is declining, squeezing revenues available to help fund universal service costs. Meanwhile, compensation and benefits costs are rising despite workforce downsizing. The Service's financial liabilities and obligations of roughly $70 billion to $80 billion include about $50 billion to $60 billion in unfunded retiree health benefits. Progress is needed to move toward prefunding these benefits, and to increase productivity to offset rising costs, rationalize the Service's infrastructure and workforce, and implement more market-based and performance-oriented compensation systems for all employees. However, progress is hindered by limited flexibility and incentives for success under current law.

First-Class Mail Volume Growth/Decline, Fiscal Years 1984 through 2004
Percentage change over previous year



Source: U.S. Postal Service

Key elements for postal reform include clarifying the Service's mission and role so that the Service remains focused on universal postal service and competes appropriately; enhancing the Service's flexibility to operate in a businesslike manner with a governance structure suitable for a $70-billion entity, balanced by enhanced transparency, accountability, and oversight; making needed human capital reforms; and moving toward prefunding retiree health benefits.

Chairman Collins, Senator Lieberman, and Members of the Committee:

I am pleased to be here today to participate in this hearing on postal reform. Today, I will focus on (1) the Postal Service (the Service) results since we put its transformation efforts and long-term outlook on our High-Risk List in 2001, (2) the need for comprehensive postal reform, and (3) selected key areas for postal reform. This testimony is an update of our last statement to the Committee.[1] Our bottom line is that the Service has made significant progress since 2001, but its recent financial success was largely due to a transitory boost provided by 2003 pension reform legislation. Comprehensive postal reform is urgently needed because the Service's fundamental transformation challenges continue to exist, thereby placing universal postal service at risk. Because comprehensive postal reform legislation has not been enacted and the Service continues to face formidable, competition, cost and other challenges, its transformation efforts and long-term outlook remain on our High-Risk List. More specifically:

- The Service has made significant progress since fiscal year 2001, including achieving record net income, repaying debt, achieving additional productivity increases, and downsizing the postal workforce.[2] However, most net income was due to a 2003 law[3] that reduced Service pension benefit payments for fiscal years 2003 through 2005. Starting in fiscal year 2006, these "savings"[4] must be set aside in a dedicated escrow account. Under the 2003 law, the Service cannot use the funds in the escrow account unless Congress eliminates the escrow requirement or specifies by law how the escrow funds may be used. Legislative proposals would abolish the escrow and require the Service to begin prefunding existing and future Service obligations for retiree health benefits.
- Comprehensive postal reform legislation continues to be needed to address the fundamental financial, operational, governance, and human

[1]GAO, *U.S. Postal Service: Key Reasons for Postal Reform*, GAO-04-565T (Washington, D.C.: Mar. 23, 2004).

[2]GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005)

[3]The Postal Civil Service Retirement System (CSRS) Funding Reform Act of 2003 (P.L. 108-18) was enacted in response to Office of Personnel Management's finding that the Service was on course to overfund its CSRS obligations.

[4]GAO, *Postal Pension Funding Reform: Issues Related to the Postal Service's Proposed Use of Pension Savings*, GAO-04-238 (Washington, D.C.: Nov. 26, 2003).

capital challenges that continue to threaten the Service's long-term ability to remain self-supporting while providing high-quality, universal postal service at affordable rates. The Service's core business of First-Class Mail continues to decline, squeezing revenues available to pay universal service costs. Meanwhile, compensation and benefits costs continue to rise despite decreases in the number of postal employees. The Service's financial liabilities and obligations of roughly $70 billion to $80 billion are comprised of roughly $50 billion to $60 billion in unfunded retiree health benefits. The current pay-as-you-go approach for these benefits will likely lead to more dramatic and frequent postal rate increases in the future. Progress is needed to move toward prefunding these benefits as well as increasing productivity to offset rising costs, rationalizing and restructuring the outmoded postal infrastructure, rightsizing the postal workforce, and implementing more market-based and performance-oriented compensation systems for all employees. In this regard, progress is hindered by the Service's limited flexibility and incentives for success under current law.

- Key areas for postal reform include clarifying the Service's mission and role so that the Service remains focused on universal postal service and competes appropriately; enhancing the Service's flexibility to operate in a businesslike manner with a governance structure suitable for a $70-billion entity, balanced by enhanced transparency, accountability, and oversight; making needed human capital reforms; and moving toward prefunding retiree health benefits. It is important that Congress act before the Service faces a crisis that could limit congressional options, particularly because it will take time for the Service to implement any major changes.

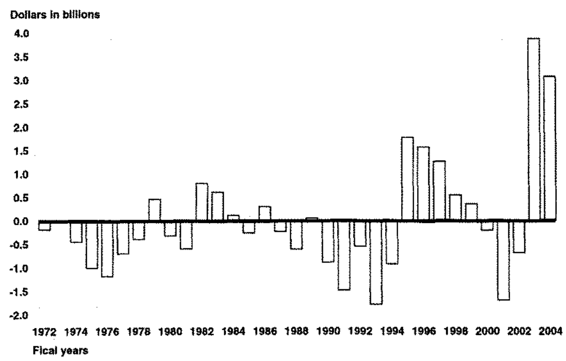
Postal Service Progress

In this section of my testimony, I will highlight significant progress the Service has made since we placed its transformation efforts and long-term outlook on our High-Risk List.

Record Net Income Largely Resulted from Pension Legislation

The Service earned a total of $7 billion in fiscal years 2003 and 2004 combined (see fig. 1) and expects to earn more than $1 billion in fiscal year 2005. However, this net income largely resulted from 2003 legislation that reduced Service pension benefit payments by $6.2 billion in fiscal years 2003 and 2004 combined and $2.8 billion in fiscal year 2005. This legislation has enabled the Service to keep postal rates stable since 2002 and promise not to raise rates until 2006. Absent the 2003 legislation, the Service likely would already have raised postal rates to avoid deficits. Net income also benefited from higher revenues associated with increased volumes of Standard Mail (primarily advertising), as well as certain Service cost-cutting and efficiency initiatives.

Figure 1: Postal Service Net Income, Fiscal Years 1972 through 2004



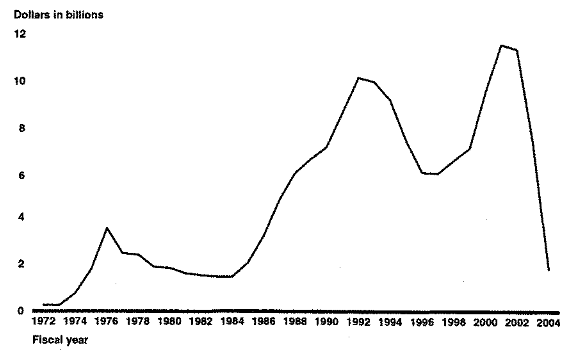
Source: U.S. Postal Service.

The Postal Service Has Repaid Most of Its Debt

Postal Service debt was reduced from a peak of $11.3 billion at the end of fiscal year 2001 to $1.8 billion at end of fiscal year 2004 (see fig. 2). Debt repayment, which has continued in fiscal year 2005, was primarily enabled by pension legislation, previously discussed in this testimony, as well as restraint over capital spending that further reduced the Service's need for borrowing. For example, the Service imposed a temporary freeze on most new capital facility projects in fiscal year 2001 that has since been lifted.[5]

[5]Congress appropriated more than $1 billion to the Service for emergency preparedness funding, including $503 million in December 2004. The Service has requested $51 million in emergency preparedness appropriations for fiscal year 2006.

Figure 2: Postal Service Debt, Fiscal Years 1972 through 2004

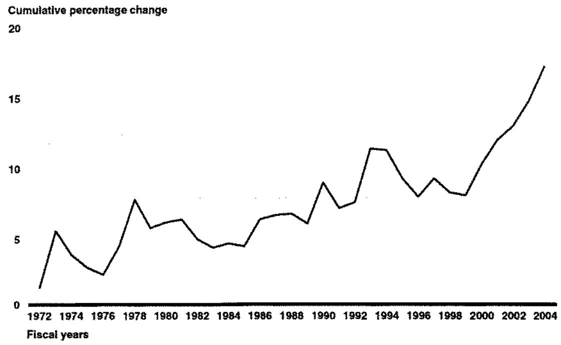


Source: U.S. Postal Service.

Postal Service Productivity Has Continued to Increase

Postal Service productivity increased by 5.2 percent from fiscal years 2001 to 2004, reaching its highest level since fiscal year 1972 (see fig. 3). Productivity rose as a result of many factors, notably cost containment resulting from large reductions in work hours enabled by automation, information technology and other efficiency initiatives; as well as restraint over capital spending.

Figure 3: Cumulative Productivity Growth, Fiscal Years 1972 through 2004

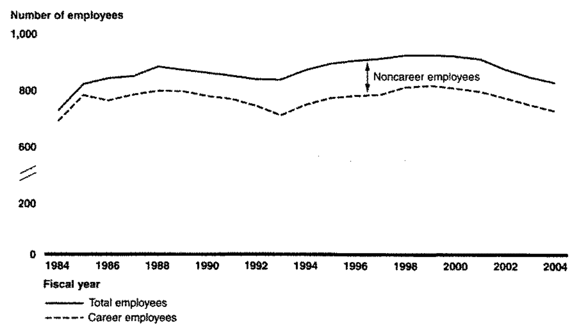


Source: U.S. Postal Service.

The Postal Service Has Downsized Its Workforce

The Postal Service downsized its workforce by 9.4 percent from fiscal years 2001 to 2004; primarily from reductions in the number of career postal employees (see fig. 4). This decline reduced the size of the Service's career workforce to about 707,000 at the end of fiscal year 2004, which was its lowest level since fiscal year 1993. Workforce reductions were made through attrition instead of layoffs, as employees retired and were not replaced, notably in mail processing and administrative functions affected by automation and information technology. Moreover, the number of career letter carriers was also reduced slightly despite a 3 percent increase in the number of delivery points, as more mail was sorted by automation equipment into the order of delivery.

Figure 4: Number of Postal Service Employees, Fiscal Years 1984 through 2004



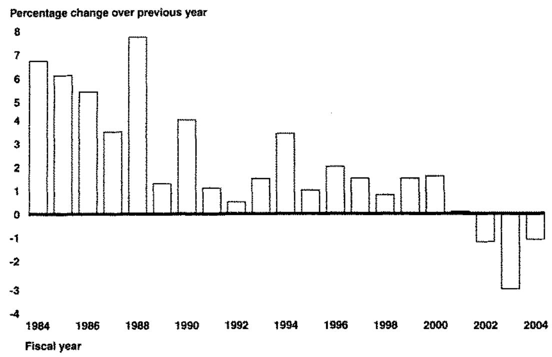
Source: U.S. Postal Service.

The Need for Postal Reform

Key trends and challenges demonstrate the need for postal reform:

Declining First-Class Mail volume: The Service's core business of First-Class Mail volume growth has shown a downward trend since the mid-1980s and declined annually since fiscal year 2001—a first-time occurrence (see fig. 5). This trend is expected to continue for the foreseeable future, as customers continue to increase their use of electronic alternatives for communications and payments.

Figure 5: First-Class Mail Volume Growth/Decline, Fiscal Years 1984 through 2004

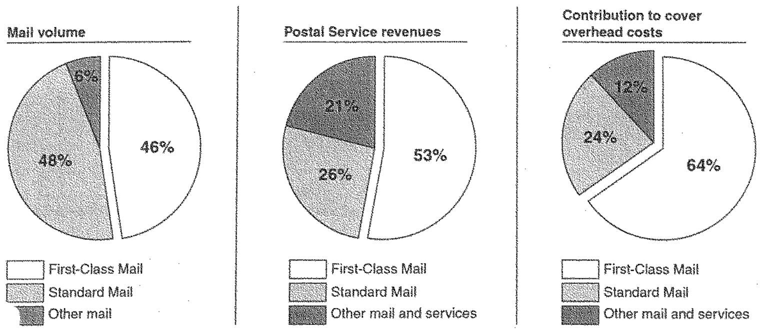


Source: U.S. Postal Service.

Declining First-Class Mail volume poses a fundamental challenge to the Service's long-term viability. First-Class Mail generates about half of the Service's mail volume, more than half of its revenues, and covers more than two-thirds of the Service's overhead costs (see fig. 6). About half of overhead costs, also referred to as institutional costs,[6] are comprised of the universal service costs of maintaining postal delivery and retail networks. Declining First-Class Mail volume is causing a loss of First-Class Mail revenues to cover overhead costs, which will be difficult to recover from other classes of mail.

[6]Institutional costs comprise roughly 40 percent of all postal costs and are defined as costs that are not attributed to specific products and services.

Figure 6: Mail Volume, Revenues, and Contribution to Cover Overhead Costs, Fiscal Year 2004



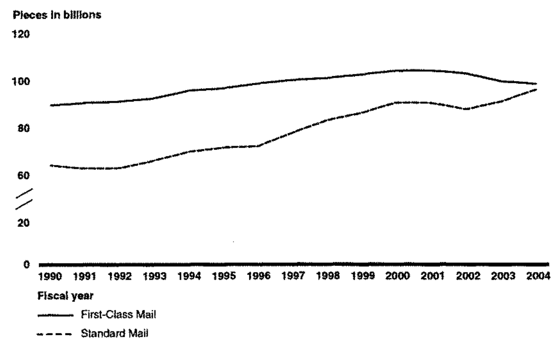
Source: U.S. Postal Service.

Note: Contribution data are the most recent available according to Postal Rate Commission methodology.

[a]Other mail includes mail such as magazines, newspapers, and parcels. Other services include postal services such as post office boxes, money orders, and delivery confirmation.

Changes in the mail mix: The shift in the Service's mail mix from First-Class Mail to Standard Mail has resulted in shrinking revenues to cover overhead costs. Standard Mail volume grew to nearly match First-Class Mail in fiscal year 2004 (see fig. 7) and is expected to exceed First-Class Mail in fiscal year 2005. However, compared with First-Class Mail, the average piece of Standard Mail generates only about half of the revenues and less than 40 percent of the contribution to cover overhead costs.

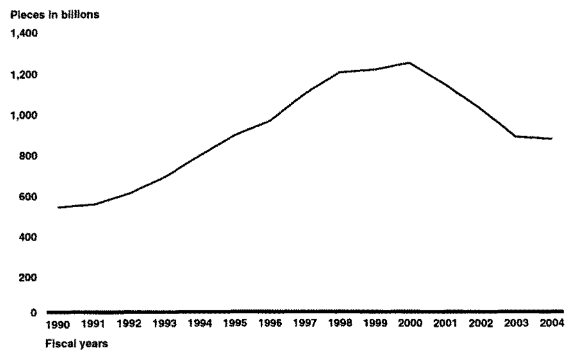
Figure 7: First-Class Mail and Standard Mail Volume, Fiscal Years 1990 through 2004



Source: U.S. Postal Service.

Increased competition from private delivery companies: Private delivery companies dominate the market for parcels over 2 pounds and appear to be making inroads into the market for small parcels. Once a highly profitable growth product for the Service, Priority Mail volume has declined about 30 percent since its volume peaked in fiscal year 2000 (see fig. 8) as the highly competitive parcel market has turned to lower-priced ground shipment alternatives. Express Mail volume has also declined for the same reason. Adding to the competition, United Parcel Service (UPS) and FedEx have established national retail networks through UPS's acquisition of MailBoxes Etc., now called UPS Stores, and FedEx's acquisition of Kinko's.

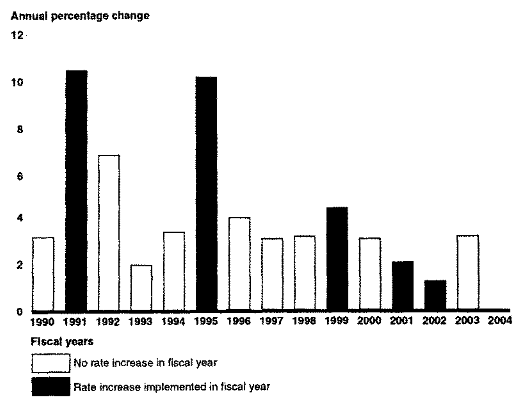
Figure 8: Priority Mail Volume, Fiscal Years 1990 through 2004



Source: U.S. Postal Service.

Subpar revenue growth: Postal revenue growth has slowed in recent years (see fig. 9) due to declining First-Class Mail volume and shifts in the mail mix to lower-margin products. As noted previously, the Service's record net income was largely due to lower pension costs instead of rising mail revenues. If revenues continue to be affected by mail volume trends, that will lead to greater reliance on rate increases to produce needed revenues.

Figure 9: Postal Service Revenue Growth, Fiscal Years 1990 through 2004



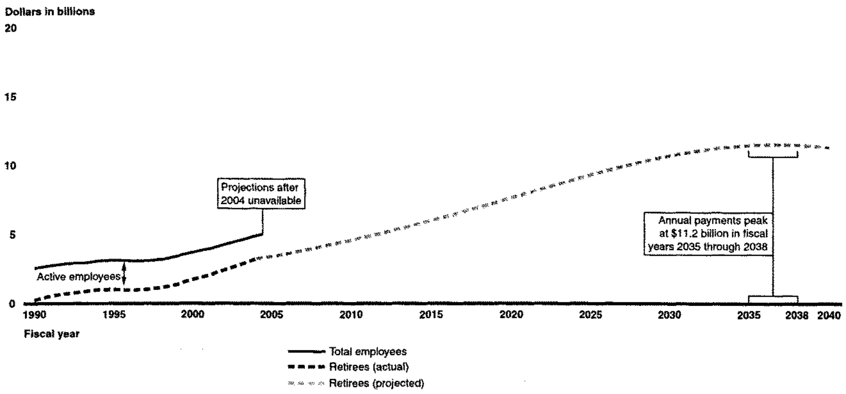
Source: U.S. Postal Service.

Note: Average postal rates increased 19.9 percent in fiscal year 1991, 10.2 percent in fiscal year 1995, 2.8 percent in fiscal year 1999, 6.3 percent in fiscal year 2001, and 7.7 percent in fiscal year 2002.

Rising costs: Key Service costs continue to rise despite continued downsizing and cost-cutting efforts, creating upward pressure on postal rates. In fiscal year 2004, Service compensation and benefit costs increased $1.7 billion, despite a decrease of nearly 22,000 career employees from the prior fiscal year. This cost growth was due to (1) wage increases for craft employees, including cost-of-living adjustments plus basic pay increases; (2) rising benefits costs, including about $500 million in additional health benefits costs for active employees and retirees; and (3) additional workload to serve 1.8 million new delivery points and handle increased Standard Mail volume.

Significant financial liabilities and obligations: The Service estimated it had roughly $70 billion to $80 billion in liabilities and obligations at the end of fiscal year 2004, including roughly $50 billion to $60 billion in unfunded retiree health benefits that were not reported on its balance sheet. Given the Service's workforce demographics and health care trends, its payments for retiree health benefits are projected to rise throughout the next 3 decades (see fig. 10). The Service will have difficulty financing these benefit costs, particularly if unfavorable revenue and cost trends continue.

Figure 10: Postal Service Health Benefits Costs, Fiscal Years 1990 through 2040



Source: U.S. Postal Service.

Note: Projections are based on current law.

Need for substantial improvements in postal productivity: Substantial productivity increases continue to be needed to help keep postal rates affordable, particularly given trends in declining First-Class Mail volume and rising costs. Some productivity increases may result from initiatives to standardize processes among mail processing plants where productivity varies widely. However, it is important to recognize that the current legal framework provides the Service with limited incentives for increasing its productivity. Under the Service's break-even mandate and statutory monopoly to deliver letter mail, no matter how little productivity increases, the Service can raise rates to cover rising costs. However, as postal management has recognized, while raising rates may provide an immediate boost to postal revenues in the short run, raising rates may also accelerate the diversion of First-Class Mail to other alternatives, thus exacerbating the Service's problems in the long run.

Uncertainties regarding postal infrastructure: The Service is using an "evolutionary" approach to develop a more efficient and flexible infrastructure but has disclosed limited information about its overall plans. The Service risks falling short of achieving its goals of rationalizing its infrastructure and workforce and removing excess capacity from its mail processing, distribution, and transportation networks unless it has a clear strategy that includes a comprehensive and integrated plan along with clear criteria as a basis for its decisions, measures to assess the impact of actions taken, and a process for informing key stakeholders, including the Congress.

Key Areas for Postal eform

Postal reform is needed to address the following key areas:[7]

- *Mission and role*: Congress needs to (1) clarify the Service's mission, because current law has enabled the Service to engage in unprofitable initiatives that are unrelated to its core mission, as well as (2) clarify the Service's role in competing fairly, including its monopoly to deliver letter mail, its authority to regulate the scope of its own monopoly, and other terms of competition.
- *Governance, transparency, and accountability*: Congress needs to (1) delineate public policy, operational, and regulatory responsibilities; (2) ensure managerial accountability through a strong, well-qualified corporate-style board that holds its officers responsible and accountable for achieving real results; and (3) define appropriate reporting mechanisms to enhance the Service's transparency and accountability for financial and performance results.
- *Flexibility and oversight*: Congress needs to balance (1) increased flexibility for the Service to operate in a businesslike manner, through streamlining the rate-setting process and allowing a certain amount of retained earnings, with (2) enhanced oversight by an independent regulatory body to protect postal customers against undue discrimination, restrict cross-subsidies, and ensure due process. In addition, the Service

[7] *U.S. Postal Service: Key Elements of Comprehensive Postal Reform*, GAO-04-397T (Washington, D.C.: Jan. 28, 2004); *U.S. Postal Service: Bold Action Needed to Continue Progress on Postal Transformation*, GAO-04-108T (Washington, D.C.: Nov. 5, 2003).

needs additional flexibility and incentives to rightsize its infrastructure and reshape its workforce. Additional flexibility should be balanced by safeguards to prevent abuse as well as enhanced transparency, accountability, and oversight, starting with appropriate disclosure of the Service's large financial liabilities and obligations.

- *Human capital reforms and pension benefit costs*: Congress needs to consider legislative proposals that would (1) revise the Service's current responsibility for pension costs related to military service, (2) move toward prefunding retiree health benefits, and (3) abolish the escrow account established in recent pension legislation. Congress also needs to decide whether postal workers' compensation benefits should be on par with those in the private sector and to clarify related pay comparability standards. In any event, progress continues to be needed toward flexible, contemporary, performance-oriented, and market-based compensation systems for all Service employees, consistent with proven approaches to strategic human capital management.

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

Contact and Acknowledgments

For further information regarding this statement, please contact Katherine Siggerud, Director, Physical Infrastructure Issues at (202) 512-2834 or at siggerudk@gao.gov. Individuals making key contributions to this statement included Teresa Anderson, Kenneth E. John, Shirley Abel, Kevin Bailey, Gerald P. Barnes, Nancy Boardman, Linda Calbom, Margaret Cigno, Kathleen A. Gilhooly, Donna Leiss, and Laura Shumway.

UNITED STATES
OFFICE OF PERSONNEL MANAGEMENT
WASHINGTON, DC 20415-1000

OFFICE OF THE DIRECTOR

April 20, 2005

The Honorable Ted Stevens
Committee on Homeland Security and Governmental Affairs
United States Senate
340 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Stevens:

I appreciated the opportunity to testify before the Committee on Homeland Security and Governmental Affairs on April 14 regarding reform of the United States Postal Service. At that hearing, you expressed concern that continuing to require the Postal Service to fund the cost of military service credit under the Civil Service Retirement System (CSRS) might somehow be detrimental to the employment of veterans returning from active duty. I would like to take this opportunity to respond in order to address your concerns.

Foremost, this Administration and the Office of Personnel Management are extremely proud of our record of support for veterans. As the President's chief advisor in human capital, OPM is fully dedicated to ensuring veterans receive the rights and benefits to which they are entitled under all veterans' employment laws. As such, OPM has long been at the forefront of efforts to preserve and protect veterans' preference as we share the view that our Nation owes a debt of gratitude to its veterans who left their families, home, and hearth to answer the Nation's call to arms. OPM's commitment to veterans' employment issues transcends veterans' preference in hiring. We also regulate entitlements for federal employees who are called to active duty and preference eligibles during periods of restructuring.

As you accurately noted in your statement, you were the principal Senate architect of the Federal Employees Retirement System (FERS), which was carefully designed to protect the interests of veterans. In that regard, the Senate-passed version of FERS, S. 1527 of the 99th Congress, as described in the report of the Senate Governmental Affairs Committee, S. Rep. 99-166, at 29 (1985), would have required the Department of Defense to reimburse the Retirement Fund for the cost of military service credit. However, as noted in the Conference Committee report, H.R. Rep. No. 99-606, at 127 (1986), the conferees made the decision that the cost of military service credit (other than a 3 percent deposit required to be made by employees for their military service) should instead be absorbed by the employing agencies.

Under FERS, military service is creditable towards benefits. Other than the 3 percent deposit, the cost of providing that credit is incorporated in the same manner as other elements of the system, and is paid for by the Postal Service in the same manner as by all other agencies. All employing agencies contribute the same percentage of basic pay of their employees, regardless of whether the employee is a veteran. Thus, it does not cost agencies a single penny more in retirement costs to hire a returning veteran over a non-veteran. Since CSRS has been closed for two decades, and since all returning veterans who become employed with retirement eligibility are under FERS, there is no possible way that this issue of CSRS funding could adversely affect the employment of returning veterans.

I would also reiterate that in making our calculations of the Postal Service's costs under CSRS, we used the same funding model that is used under FERS. We firmly believe that the FERS funding provisions are equitable with regard to veterans. It thus follows that if it is fair to have agencies pay the cost of military service credit under FERS, then it is equally fair to provide the same treatment to the Postal Service and all other organizations paying the full costs of CSRS for their employees. The existing law has that result, as provided under the provisions of Public Law 108-18 for the Postal Service.

As noted in my testimony, there have been several situations where the Congress has required organizations to pay full CSRS costs, including the Postal Service and several other smaller entities. In each case, the requirement has been limited to costs attributable to employment after initiation of the full retirement funding obligation. Because the public policy for full Postal funding of its costs began in 1971, we computed the Postal Service share of the military service excluding military service costs attributable to employment with the former Post Office Department prior to the establishment of the United States Postal Service. This apportionment of the cost of military service excluding military service credit costs attributable to pre-1971 employment resulted in the Postal Service being relieved of the obligation to pay $21 billion. It is fair and equitable that military service credit costs attributable to later service remain the obligation of the Postal Service.

Thank you for allowing me this opportunity to address your questions and I am pleased to be able to clarify this matter for the record.

Sincerely,

Dan G. Blair

Dan G. Blair
Acting Director

cc: The Honorable Susan M. Collins

U.S. Senate
Committee on Homeland Security &
Governmental Affairs

Hearings on
U.S. Postal Service:
What is Needed to Ensure its Future Viability?
April 14, 2005

Dangers of Imposing Restrictions on Worksharing in Postal Reform Legislation

Statement of
Diane J. Elmer
on behalf of
Cox Target Media, Inc.
(Valpak Direct Marketing Systems, Inc.)
8605 Largo Lakes Drive
Largo, Florida 33773-4910

STATEMENT OF DIANE J. ELMER ON BEHALF OF COX TARGET MEDIA, INC. (VALPAK DIRECT MARKETING SYSTEMS, INC.) APRIL 14, 2005

EXECUTIVE SUMMARY

The Postal Service is an organization under pressure. The world around it is changing. The availability of alternatives to traditional mail is expanding, thereby increasing competition and forcing the Postal Service to operate in a more businesslike manner. The rates that the Postal Service charges are of critical importance, both to itself and to mailers. **Rates must be set carefully, employing valid economic principles, not simply based on achieving some parochial objective, such as protecting as many mail processing jobs as possible within the Postal Service.**

If rates are set properly, the strengths of the Postal Service can be made available to mailers at a reasonable price. At the same time, mailers can be given the opportunity to do what they do best — control their operations, plan their mailings, and submit efficient, low-cost mail. But if rates are not set properly, or if they are constrained artificially, costs can rise, the strengths of mailers can go untapped, and the decline in volume can continue, even accelerate.

In recent years, partly through the creation of new rate categories, rates have come to be based in greater degree on the Postal Service's costs. Between these rate categories, mailers are allowed what are often called worksharing opportunities. In effect, mailers can change the way their mail is prepared, lower combined postal and mailer costs, and increase overall efficiency. This process has been effective and it should continue.

Significantly, no mailer has complained about worksharing. Unfortunately, however, worksharing has come under attack from certain postal unions who want postal reform legislation to set **political constraints on the ratesetting process** to ensure that mail processing jobs are retained within the Postal Service regardless of the economic consequences.

Worksharing today is a major economic activity, and is not separable from other aspects of ratesetting. It should be considered in a balanced way, along with other considerations. The worksharing provisions in S.662 would single out rates with worksharing dimensions, highlight them for emphasis beyond other considerations, and place them under rigid strictures. They would elevate estimated cost avoidances to a unique level of special scrutiny, above that of other cost considerations and important ratesetting considerations, even though cost avoidances are difficult to estimate, vulnerable to considerable manipulation and require risky speculation on how mailers might respond to different rate alternatives.

More particularly, under any plain reading, the restrictions proposed would put an abrupt stop to further progress in the area of worksharing as proposed by the President's

Commission and may well even require that the existing discounts be rescinded. In fact, had these restrictions been in place all along, virtually none of the current worksharing discounts could have evolved, to the detriment of the Postal Service, mailers, and the efficiency of the mailing community.

We do not believe than any of these consequences are intended by sponsors of this legislation. As currently proposed, this postal legislation is incredibly complex, and, if enacted, we believe it would have innumerable unintended consequences. However, we have focused this statement on the worksharing provisions to demonstrate how they would operate and why they should be withdrawn.

Ratesetting is a complex process that should not be micro-managed through legislation. The ratesetting authority should be encouraged to recognize sound principles and a range of factors, in a balanced way, as appropriate. Flexibility and discretion are needed. The provisions on worksharing in S.662 would straitjacket the process, at great cost to mailers and the Postal Service. The provisions that single out and restrict worksharing need to be removed from the bill.

Finally, on September 30, 2003, pursuant to P.L. 108-18, the Postal Service submitted its proposal for the use of its mandated overpayment of CSRS retirement funds, which current law requires be paid into an escrow account. Despite language in the bill indicating that Congress would act within 90 days, mailers have now seen the passage of 18 months since the submission of that report, and Congress has not yet acted.

Rather than include some CSRS fix in a postal reform bill which has been losing support in the mailing community, we would urge Congress to remedy the CSRS and military retirement problems now, via the mechanisms made available in P.L. 108-18, and then revisit postal reform thereafter.

VALPAK DIRECT MARKETING SYSTEMS, INC.
VALPAK DEALERS' ASSOCIATION, INC.

Thank you for the opportunity to present to the Committee the statement of Cox Target Media, Inc., Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. ("Valpak") with respect to pending postal reform legislation.

Valpak Direct Marketing Systems, Inc. is a wholly-owned subsidiary of Cox Target Media, Inc., and is a substantial mailer, primarily using Standard Mail. Valpak is the nation's largest firm in the subset of the hard-copy, cooperative direct mail advertising industry which is sometimes referred to as "coupons in an envelope."

Valpak operates throughout the United States through approximately 190 franchisees which are members of the Valpak Dealers' Association, Inc. The work of these franchisees is supplemented by efforts of approximately 1,200 sales representatives.

Valpak's headquarters are located in Largo, Florida. Valpak also prints at, and mails from, a large facility in Elm City, North Carolina. Valpak mails over 500 million pieces annually.

Our business is enormously reliant on the United States Postal Service. We have earnestly and consistently supported the Postal Service in carrying out its basic mission — to deliver the mail, rapidly and economically. We need and want the Postal Service's delivery business to thrive and prosper in coming years.

Valpak has been an active intervenor before the Postal Rate Commission in numerous rate, classification, and rulemaking cases since 1995.

S.662 RESTRICTIONS ON WORKSHARING

S.662, the Postal Accountability and Enhancement Act, introduced March 17, 2005, contains several provisions that focus narrowly on postal worksharing and **materially reduce flexibility in ratesetting**. Accordingly, they also reduce the likelihood that the Postal Service can function effectively and remain a viable institution in the future. These provisions are set out in Appendix A, at the end of this testimony.

1. Unintended Consequences of Worksharing Restrictions

The Postal Service has become a world-wide leader in initiatives that have promoted worksharing, but this bill would stop progress in its tracks and reverse 25 years of improvements. The amazing unintended consequence of the worksharing restrictions in S.662 is that it puts in jeopardy the entire system of worksharing. Under the bill, the Postal Service must make certain certifications for worksharing discounts to be established or maintained. The bill does not expressly state what would happen if the Postal Service cannot make these certifications. However, it would appear that failure to make such certifications **could mean that all currently existing worksharing discounts by commercial mailers be terminated, and no new worksharing discounts ever be created**. This certainly is not the intention of most supporters of this bill. As demonstrated herein, however, it appears that this would be its effect.

Section 3622(e)(3)) of S.662 (quoted in its entirety in Appendix A), requires:

> Whenever the Postal Services **establishes** or **maintains** a workshare discount, [it] shall ... submit ... a **detailed report** that ... certifies that the discount will **not adversely affect ... [mailers] . . . who do not take advantage** of the discount rate. [Emphasis added.]

This section would be a virtual bar to the creation or maintenance of worksharing discounts, even if they were set at no greater than the level of avoided cost. It would create enormous burdens for commercial mailers.

First, in the case of virtually every worksharing discount currently in existence, **some mailers were performing the worksharing activity before the discount was established.** This means that, from the outset, virtually every worksharing discount involved an element of de-averaging of rates. Excepting instances where the discount is held well below the cost avoidance and all savings from growth in worksharing is used to maintain the rate of nonparticipating mailers, de-averaging tends to increase rates for those that do not take advantage of the discount (and whose mail inevitably causes the Postal Service to incur higher costs), and decrease rates for those who do the worksharing. **Under the proposed legislation, therefore, it seems unlikely that the existing discounts ever could have been established.**

Second, a showing of "no rate increase" would have to be made in order to **maintain** all existing discounts. Since it is highly likely that the **discontinuance** of any worksharing discount in existence today would allow rates to decline for some mailers who do not participate and take advantage of the discount, it follows that **maintenance** of discounts would cause rates for nonparticipating mailers to be higher. The direct implication is that such certifications cannot be made, and **it would appear that all existing discounts would have to be discontinued.**

Part of the success of the current rates is that they give mailers a strong incentive to direct their energy toward ways of accomplishing final delivery at a lower overall cost, sometimes by preparing and tendering mail in improved ways that require less processing. Valpak has invested heavily in such efforts, and we are not alone. Enactment of this bill would respond to these mailer efforts by imposing strict rules that would limit worksharing and attempt to create unnecessary work for high-cost postal employees. The direct consequence will be to increase the cost of mailing, and **the unintended consequence could be dramatic reductions in the volume of low-cost, high-profit mail entering the USPS network.** This misdirected effort at job protection will stymie efforts to develop creative ways that lower the costs for all concerned. For the good of the Postal Service, it should not be allowed to happen.

We believe that the appropriate role of legislation is to provide policy guidelines, and not attempt to micro-manage processes like the setting of postal rates, which requires flexibility and responsiveness. Postal markets are in a state of flux and, ironically, that is one reason reform legislation is even being considered. Yet under the worksharing provisions in S.662, certain rates are being singled out for strictures and adverse treatment. The restrictions thus created would trump all other rate design considerations, including the longstanding requirement that postal rates take into account the **degree of preparation of the mail**. They would make rational ratesetting impossible. These provisions will do great harm to the Postal Service and to mailers.

These two implications alone are sufficient to stop progress and, if the obvious interpretation is correct, to cause movement back toward conditions that existed some 35 years ago. Even if this flaw could be remedied, substantial additional problems arise with the way the bill addresses worksharing, as discussed in the following sections.

2. Worksharing Is Not Separable from Other Aspects of Good Ratesetting

The proposed legislation categorizes the **transportation** of mail as a **worksharing** activity. What actually occurs is that the Postal Service offers lower rates when mail is entered at destination facilities, because such mail causes a lower amount of transportation cost to be incurred. As explained below, these lower rates for **destination entry** sometimes create extensive worksharing, other times minor worksharing, and no worksharing at all in some instances.

In making decisions relating to such transportation, mailers look at rate differences. If the rate for entry at a Postal Service origin facility is 10 cents (per pound) and the rate for entry at a Postal Service destination facility is 4 cents, the mailer contemplating transportation considers the 6-cent rate difference to be a dropship discount, and compares it to his own transportation cost. If he can transport the mail for less than 6 cents, he will do so, and the difference between his transportation cost and that of the Postal Service (the latter referred to in worksharing parlance as an avoidance) becomes a net gain. In the case of Valpak, we transport all of our mail to destination facilities, even across the country, because it saves us money.

But the matter is far from simple. For example, consider one mailing that originates 2,000 miles from its destination and another mailing that originates only 500 miles from its destination. No one destination entry rate difference reflects the different transportation cost avoidances of these two mailings. Accordingly, dropship decisions cannot be made on the basis of comparing mailers' transportation costs with those of the Postal Service. Further, the typical mailer has no information at all concerning the transportation costs of the Postal Service.

Currently, the dropship discount is based on the difference in cost between nationwide mail (that entered in an origin office) and dropshipped mail. The average haul of nationwide mail is unknown, but could be expected to be in the range of 700 miles. The average haul of dropshipped mail is virtually zero. Accordingly, the dropship discount is based on the Postal Service avoiding the cost of carrying the mail 700 miles. Under these conditions, close-in mailers are much more likely to dropship than distant mailers, and might well do so even where their transportation costs are higher than those of the Postal Service on a pound-mile basis. Clearly **the issue of what is defined as worksharing in the bill involves more complexity than what is generally considered to be worksharing**.

Further, **some mailers mailing locally are already located at or near their destination office**. For example, a Cleveland, Ohio cataloger might be expected to enter his catalogs destined for the Cleveland area at the Cleveland post office, which is his destination office. He does not incur transportation costs to do this. But it should be viewed as a matter of some importance that he pay a rate based on the Postal Service's cost to handle his mail. That is, **the Cleveland rate for Cleveland mail should be based on the costs incurred by the Postal Service to process and deliver that mail**. It should not matter how far the mailer drives his truck. Destination entry rates achieve this goal.

Lastly, **rates set strictly on avoidances would not necessarily be responsive to competitive pressures**. For example, in major metropolitan areas such as Cleveland, the Postal Service faces competitors for delivery of a range of items, and the extent of this competition is expected to increase. Indeed, the need to be responsive to such pressures is one reason legislative reform is being considered. A competitor in Cleveland would base his rates on his costs, not on some scheme relating to nationwide costs and avoidances. The Postal Service needs to respond by looking at its Cleveland costs, too. **A restricted focus of the kind required in this bill could easily bar the Postal Service from being able to respond to competition**.

Transportation is not the only instance in which notions of worksharing are only part of the story. Local newspapers and utilities routinely presort and enter mail at their destination office. **Fair and effective rates for such mailers require attention to issues that go beyond cost avoidances**. The restrictive provisions in the bill would prohibit this type of attention.

3. Good Ratesetting Does Not Distill into a Narrow Focus on Cost Avoidances

Whenever separate rate categories are established to help align rates with costs, and to allow more efficient mailer decisions, rate differences arise. If these rate differences align well with notions of worksharing, theory suggests that weight should be given to cost avoidances. Indeed the Postal Rate Commission has provided just such weight. **But when these differences do not align well with the notion of worksharing, as explained in detail above**

for dropshipping, efficient ratesetting requires costs and markups that focus on costs that the Postal Service actually incurs, rather than on cost avoidances. In these cases, flexibility in ratesetting is needed. Placing rigid legislative constraints would snuff out such flexibility.

One goal of regulation should be, where possible, to set rates that are similar to those that would evolve under competition. Such rates are widely understood to recognize costs and demands in ways that serve consumers effectively. The problem is that competitive rates do not necessarily reflect, in a one-to-one way, attendant cost differences or avoidances. Legislation that severely limits, or even effectively prohibits, such a reflection would preclude the authority to recognize other important factors, and thus reduce efficiency of the resulting rates. Such legislation is not desirable, and would not be so even if the notion of worksharing applied in all cases. **If the Postal Service is to face competition successfully, it must not be strait jacketed by such legislative demands.**

Another aspect of efficiency requires that the **sensitivity of mail volume to the level of rates** be considered, which is to say that the **elasticity of demand** should be recognized. The volume sent by many mailers is affected strongly by rates, including especially that of my company, Valpak. If the Postal Service is forced to raise rates significantly for these sensitive categories, substantial portions of the volume will disappear, the value received by mailers will be diminished substantially, and the attempt to gain revenue muted. That will leave other mailers with increased burdens and put the Postal Service in the position of failing to provide a needed service which it is in a good position to provide. **Placing rigid constraints on the ratemaking process can impede the recognition of elasticities, thus reducing the efficiency with which mailer needs are met. Such constraints are out of line with the principles of efficient ratemaking.**

4. Effective De-averaging Involves Worksharing, Rate Decreases and Rate Increases

It is well known that many **postal rates, perhaps all of them, are based on cost averages.** The rate for a First-Class letter, for example, is based on the average cost of letters that go to all different destinations. A short-distance letter pays a rate that is inordinately above its cost, and a long-distance letter pays the same rate, which does not reflect any of its additional cost. In varying degrees, similar phenomena exist in every subclass of mail.

But **rates based on cost averages are not necessarily good rates.** They can subject the Postal Service unnecessarily (and destructively) to competition and **encourage the inefficient use of resources.** Consider these examples.

First, if the **publisher** of *Washingtonian* magazine were presented with rates that do not vary with distance, he might easily have the magazine printed on the West Coast and let the

Postal Service carry it back to Washington, for no additional postage. Averaging can bring about, even encourage, decisions that are just plain wasteful. The proposed legislation can be said to promote waste and inefficiency.

Second, if **parcel mailers** were presented a uniform national rate, a competitor could easily pick off the short distance parcels, at a profit, and leave the Postal Service with only the longer-distance, higher-cost parcels. Were this to occur, and it would occur under excess averaging, the Postal Service would fail to make available a service for which it might be the low-cost provider, and mailers would lose accordingly.

In order to avoid the deleterious effects of averaging, brought about in many cases by practices sometimes referred to pejoratively as **cherry picking, cream skimming, or adverse selection**, the Postal Service has de-averaged many rates. Whenever it does this, rates for lower-cost mailers decrease and those for higher-cost mailers increase. At the same time, options for mailers present themselves, options that are often viewed as involving worksharing. **If increases in rates for higher-cost mailers are prohibited, with strictures like those in the legislation being considered, the Postal Service will be hamstrung in its freedom to de-average and in its ability to function effectively in the marketplace.**

Nearly every improvement in rates since the enactment of the Postal Reorganization Act of 1970 has involved some degree of de-averaging, raising some rates while lowering others, and often presenting worksharing opportunities. Examples include destination entry rates for parcel post and Standard Mail (formerly third-class), and virtually all presort rates. De-averaging improves the price signals sent to mailers. It has allowed mailers to see the cost implications of the decisions they make. It has also allowed the Postal Service to be more effective in meeting mailer needs and in competing for business. The proposed legislation, however, would **stop de-averaging in its tracks**, and could cause it to go backwards, just because it might have worksharing dimensions. This should not be allowed to occur.

5. As a Practical Matter, Cost Avoidances Are Difficult to Measure and Contentious

It is true that estimates of **cost avoidances** have played an important role in developing current rates. No one contends that they should not continue to receive attention, as appropriate, as one factor among many. When this occurs, the difficulties of estimation can be addressed along with other considerations.

But if legislation specifies that cost avoidances are to receive prominent attention, and in many cases are to be the central focus of rate-making, to the extent of requiring annual detailed analyses and reports, the estimation burden will increase substantially, at great cost to the Postal Service and to mailers.

For financial and operating purposes, the Postal Service maintains a number of data systems. When costing for rate purposes took on added importance after Postal Reorganization in 1970, it was necessary to supplement these systems, at considerable additional cost. For over 30 years now, the Postal Service's costing systems have been in a state of constant evolution, and review of these systems has been a dominate consideration in rate proceedings. Many improvements have been made, including a range of special studies. Nevertheless, it remains exceedingly difficult for these systems to identify and estimate all costs that are avoided by workshared mail. Analysis of costs avoided usually focuses only on one or two types of transportation or processing steps that are avoided, where cost data exist which can be employed. **Usually only a portion of costs avoided are measured, and therefore estimates systematically understate the costs avoided by workshared mail.**

Further, all of these systems focus only on mail that exists within the postal network. **By definition, the Postal Service's costing and accounting systems measure only costs incurred. Those systems cannot measure the costs avoided by mail that is not processed or transported within the postal network, as they are not incurred. Any attempt to estimate that which does not actually exist calls for some degree of speculation.** A legislated requirement that such costs be studied would likely lead to an increased cost burden on the Postal Service (which, in the end, would have to be paid by mailers), more contention concerning the quality of the estimates, and more review before the Postal Rate Commission. If history is any guide, disagreements surrounding this additional costing work would be battled out in the courts.

Such exclusive focus on cost avoidances is not warranted. The additional costs are too high. The return is likely non-existent and might well be negative, as a balanced review is precluded. It would be much better to allow the Postal Rate Commission, as now, to address the need for avoidances with perspective. Singling out worksharing in this way in federal legislation is ill-advised. It should be avoided.

6. Narrow Focus on Cost Avoidances Ignores 40 percent of Postal Service Costs

S.662 provides that:

> the Postal Regulatory Commission shall establish rules for workshare discounts that ensure that such **discounts do not exceed the cost** that the Postal Service **avoids** as a result of workshare activity, **unless** — [one of several peculiar and transitory factual situations are present.]

Cost avoidances currently focus on the attributable costs (predominately volume variable costs) saved by a mailer performing tasks that would have caused the Postal Service to incur costs if it had handled that mail. Only about 60 percent of all postal costs are attributed. The 40 percent of postal costs which are not attributed are considered institutional, and are recovered through a markup on attributed cost. (The systemwide average markup is thus about 67 percent). Limiting worksharing discounts to costs avoided makes no provision for these institutional costs.

When viewed in this way, the implicit price charged by the Postal Service for mail processing and transportation bears no part of the institutional costs of the Postal Service. **Under S.662, the Postal Service is forced to "sell" mail processing and transportation "at cost" with no markup.** For example, no private competitor which competes with the Postal Service would offer package sortation at cost, but would mark it up to cover its own institutional over-head costs. Likewise, the Postal Service should not be forced or allowed to underprice processing and transportation at cost.

CONCLUSION

Worksharing is an important notion, which already receives attention in ratesetting, but it is one dimension among many. No rational economic or business basis exists for singling it out for extreme emphasis and legal strictures. The legislation under consideration, depending in some degree on how it is interpreted, easily could do this and more. It could take away the flexibility the Postal Service needs to face the future. It could restrict the Postal Service from meeting mailer needs effectively. It could stop progress, hinder effective ratesetting, and even bring about retrogression.

Postal rates in the United States in great measure due to worksharing, are a model and a success story. Much of this success is rooted in the availability of improving cost information. Other countries look at our costs and wonder if theirs are similar, but they do not know. An offshoot of recognizing costs, no matter how good or imperfect, has been attention to notions of worksharing. **Improved mail preparation, along with worksharing, has been credited with helping to improve efficiency, realize lowest combined mailer and Postal Service cost, and increase volume.** This all has been accomplished under a ratesetting system that gives weight to a wide range of factors. Further progress should not be stunted by enacting constraints that seek to micro-manage the system, particularly when those constraints are not well aligned with pricing in the public interest. **Flexibility is needed now and will continue to be needed. The worksharing provisions in the S. 662 must be removed.**

CONGRESSIONAL INACTION REGARDING CSRS

Section 4 of the **Postal Civil Service Retirement System Funding Reform Act of 2003**, Public Law 108-18, provides that,

> **Not later than 180 days after it has received** both the proposal of the **Postal Service** and the evaluation of such proposal by the **General Accounting Office** [now the Government Accountability Office] under this subsection, **Congress shall revisit the question** of how the savings accruing to the Postal Service as a result of the enactment of this Act should be used.

As called for by that law, the **Postal Service** submitted its proposal, titled "Postal Service Proposal: Use of Savings For Fiscal Years After 2005, P.L.108-18," on September 30, 2003. The **Government Accountability Office** released its report, titled "Postal Pension Funding Reform: Issues Related to the Postal Service's Proposed Use of Pension Savings, GAO Report GAO-04-238," on November 3, 2003.

On February 24, 2005, the Board of Governors of the U.S. Postal Service wrote to Chairman Collins transmitting the position of the Postal Service on key issues in postal reform, thereby setting out its vision of the legislation:

> First the escrow requirement for the so-called savings in payments to the Civil Service Retirement System (CSRS) should be removed. This misnamed "savings" is actually a correction of a statutorily-mandated (over) payment into the retirement system. To continue to require the Postal Service to hold these funds in escrow or other account would simply continue the overpayment and unfairly burden postal ratepayers.

On March 2, 2005, the Postal Service wrote to the respective chairs of the Senate and House Budget Committees regarding the drafting and mark-up of the FY06 Budget Resolution endorsing the language on the "escrow" funds contained in S.2468, the Postal Accountability and Enhancement Act introduced and voted out of the Senate Committee on Governmental Affairs in the 108th Congress. This version of the disposition of the "escrow" account funding would be used, in part, to pre-fund retiree health benefits and in part to mitigate future rate increases, scoring at $15.7 billion from 2005-2014. The Postal Service moreover characterized the President's proposal of what it termed layering additional Postal Service retiree health benefits premiums on top of what would have gone into the escrow account as a penalty on all those who use the Postal Service by increasing rates unnecessarily.

Nevertheless, as of today, over 18 months after the Postal Service submitted its proposal, Congress has not in any meaningful way revisited the question by taking action to remedy this problem.

The financial issues of CSRS and military retirement problems require Congressional action at this time. The rest of so-called "postal reform" does not. The letter from the Board of Governors of February 24, 2005, discussed above, supports postal reform which is very different from the bills currently pending in Congress. In fact, there is no consensus in the mailing community in support of the postal reform legislation, apart from the financial issues involving CSRS and military retirement. Many mailers are only reluctantly supporting the rest of postal reform as the high price to be paid to get Congress to act on the financial issues. General postal reform legislation should be postponed until a consensus can be reached, while the CSRS and military retirement problems should be fixed now.

APPENDIX A
S. 662 EXCERPTS ON WORKSHARING

The provisions in S. 662, the Postal Accountability and Enhancement Act, introduced March 17, 2005, that focus narrowly on postal worksharing are set out below:

"Sec. 3622. Modern rate regulation

* * *

"(e) WORKSHARE DISCOUNTS-

"(1) DEFINITION- In this subsection, the term `workshare discount' refers to rate discounts provided to mailers for the **presorting, prebarcoding, handling, or transportation** of mail, as further defined by the Postal Regulatory Commission under subsection (a).

"(2) REGULATIONS- As part of the regulations established under subsection (a), the Postal Regulatory Commission shall establish rules for workshare discounts that ensure that such **discounts do not exceed the cost** that the Postal Service avoids as a result of workshare activity, **unless**--

"(A) the discount is--
"(i) associated with a **new** postal service, a **change** to an existing postal service, or with a **new** workshare initiative related to an existing postal service; and
"(ii) **necessary to induce mailer behavior** that furthers the economically efficient operation of the Postal Service and the portion of the discount in excess of the cost that the Postal Service avoids as a result of the workshare activity will be **phased out** over a limited period of time;

"(B) a **reduction in the discount would**--
"(i) lead to a **loss of volume** in the affected category or subclass of mail and **reduce the aggregate contribution** to the institutional costs of the Postal Service from the category or subclass subject to the discount below what it otherwise would have been if the discount had not been reduced to costs avoided;
"(ii) result in a further **increase in the rates paid by mailers not able to take advantage** of the discount; or
"(iii) **impede the efficient operation** of the Postal Service;

"(C) the amount of the discount above costs avoided--
"(i) is necessary to **mitigate rate shock**; and
"(ii) will be **phased out** over time; **or**

"(D) the discount is provided in connection with subclasses of mail consisting exclusively of mail matter of **educational, cultural, scientific, or informational** value.

"(3) REPORT- Whenever the Postal Service **establishes** or **maintains** a workshare discount, the Postal Service shall, at the time it publishes the workshare discount rate, submit to the Postal Regulatory Commission a **detailed report** that--

"(A) explains the Postal Service's **reasons** for establishing or maintaining the rate;

"(B) sets forth the **data, economic analyses**, and other information relied on by the Postal Service to justify the rate; and

"(C) certifies that the **discount will not adversely affect rates** or services provided to users of postal services who do not take advantage of the discount rate."

"Sec. 3652. Annual reports to the Commission

* * *

"(b) INFORMATION RELATING TO WORKSHARE DISCOUNTS- The Postal Service shall include, in each report under subsection (a), the following information with respect to **each market-dominant product for which a workshare discount was in effect** during the period covered by such report:

"(1) The per-item **cost avoided** by the Postal Service by virtue of such discount.

"(2) The **percentage** of such per-item **cost avoided** that the per-item workshare discount represents.

"(3) The per-item **contribution** made to institutional costs."

"SEC. 302. POSTAL SERVICE PLAN.

* * *

"(4) ANNUAL REPORTS-

* * *

"(B) CONTENTS- Each report under this paragraph shall include--

* * *

"(iii) an estimate of how postal decisions related to mail changes, security, automation initiatives, **worksharing**, information technology systems, excess capacity, consolidating and closing facilities, and other areas will impact **rationalization plans**;" [Emphasis added.]

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Setting The Record Straight on Postal Reform

Submitted to Senate Homeland Security and Government Affairs Committee

By

William Burrus, President
American Postal Workers Union
AFL-CIO

April 14, 2005

I appreciate this opportunity to submit testimony on behalf of the more than 300,000 members of the American Postal Workers Union, AFL-CIO (APWU). The subject of reforming the United States Postal Service is extremely important to the American public and to postal employees. APWU has been engaged in the deliberations from the beginning of this debate, and we thank the Committee and the Presidential Commission for including our voice.

Having previously explored the many facets of postal reform and expressed our views on policy issues, this testimony is offered to set the factual record straight: The sky is not falling, and new technology does not threaten the viability of the United States Postal Service.

Two generally accepted assumptions have served as the foundation for the debate on postal reform and as justification for significant change to the Postal Service's structure. First, that electronic communication has and will replace hard-copy communication, and, second, that the addition of 1.8 million new addresses annually poses an insurmountable problem for the Postal Service. These assertions have gone largely unchallenged, but they are both false.

The General Accountability Office (GAO) has asserted that the business model established by the Postal Reorganization Act of 1971 is no longer sustainable, and that substantial change is absolutely necessary, due to the advent of electronic communications. At prior hearings, the Comptroller General of the GAO cited statistics intended to support this claim, and embellished them with anecdotes about cell phone and e-mail use as examples of how technology will affect First Class Mail. However, neither the statistics nor the anecdotes support GAO's claim that change is needed.

Does the expansion of e-mail and electronic bill payment mean that a decline in hard-copy communication is inevitable? Not at all.

The communication habits of a single individual may or may not reflect the behavior of a generation; but while people communicate with each other and with business more often and in new ways, there is no evidence that increased cell phone or e-mail communication will lead to a decline in mail volume. In fact, mail volume is increasing.

The second most often cited evidence of the imminent demise of the Postal Service is the revelation that, through its universal service obligation, the Postal Service adds 1.8 million new addresses annually – the equivalent of an additional delivery commitment as large as a major city.

The addition of these new customers is presented as a negative; but any other business would welcome similar growth. General Motors would be thrilled by a projected growth of 1.8 million new customers each year. Yet in the debate over postal reform, the implication is that each of the new delivery points generates more costs than revenue. I have yet to see specific evidence to support this conclusion, but the idea contradicts the basic concept of capital expansion.

The statistics that are available indicate that delivery-point growth has been a plus. Over a 31-year period, delivery-point growth averaged 1.78 percent per year, while mail volume growth averaged 2.78 percent per year. From FY 1971 through FY 2000, mail pieces per possible delivery grew from 1,074 per year to 1,529. Even after the 9/11 atrocity, the anthrax attacks, and a lingering recession, the number of mail pieces per possible delivery declined only to 1,454 in FY 2002. With the recent growth in mail volume, there is every reason to think that growth in mail volume and growth in delivery points will continue on their historical track.

If the new addresses represent a move up the socio-economic scale, they will become a target for new or enhanced advertising. The residents will be inundated with new catalogues and credit card solicitations, and they will be offered a wide array of new services. They will engage in substantial new commerce – by mail.

To share an anecdote of my own: my family has all the technological bells and whistles available, but I receive more mail in one month than my father received over his entire lifetime.

The assumption that the use of technology will come at the expense of hard copy has been studied extensively by Fouad H. Nadr, the Managing Director of the Adrenale Corporation, which specializes in postal market, business, and technology trends. He concludes, in Background Paper No. 3, February 24, 2005, Version 2, that:

> "The PwC (Price Waterhouse Coopers.2000) scenario, in turn was presented to the government in support of USPS positions for pending reform legislation before Congress. The PwC forecast relied on the assumption that new electronic delivery channels for bills, statements and payments would significantly erode First Class Mail volume.....
>
> "Clearly, the pessimistic PwC predictions have not come to pass. PwC estimated that by 2003, 17 billion pieces of First Class Mail would be cannibalized by electronic media, bringing the volume down to less than 93 billion. Instead, the actual volume in 2003 exceeded 99 billion First Class pieces..... Yet these predictions

> continue to be overstated in the U.S. based on information supplied by data analysts.
>
> "Volume 'diversion' has considerably more to do with factors such as the loss of business customers to competitors, the reductions in business mailings to changing business practices, or the use of lower-priced products due to rationalizations following price increases....
>
> "As a prominent postal executive has said, blaming the change on substitution is too easy; the economy has much to do with mail volumes, especially mail used as an advertising medium...... Some observers are notably more optimistic about mail, claiming that, ***in the modern age, the more one communicates electronically the more likely one is to use physical mail."*** [Emphasis added.]
>
> "We have found little evidence that the national postal operators (NPOs) feel confident that their models can properly treat effects that are not yet well-understood, such as market liberalization, traditional and electronic competition, share-shifts among classes of mail, and customer rationalization when faced with price increases."

Nadr further concludes that:

> "Studies show that businesses across almost all industries have considerably increased the presort proportion of their First Class Mail sent to households, particularly since the year 2000. Presort pieces per household have actually been increasing at the rate of 5% per year in 2000-2003."

The Postal Service's addiction to excessive "worksharing" discounts encourages this trend; undermines the institution's financial underpinnings, and cannot be justified by increased volume. One of the oldest sales tricks is the saying, "I'm selling my product at a small loss, but I'll make it up in volume." Regrettably, in the case of the Postal Service, this is not a phony "line," it is policy – bad policy. The Postal Service's draft Cost and Revenue analysis for 2004 shows that postal "per piece" costs for mail processing are continuing to decline, but discounts for avoiding these increasingly efficient mail processing operations are not declining.

Excessive discounts sap the Postal Service of needed revenue and require individual citizens and small businesses to subsidize corporate business mailers.

Contrary to the hopes of many, postal reform will not cure the common cold and, in fact, it may do more harm than good. Flexible rates, transparency, new categories of competitive and non-competitive products, and bonus authority are all positive objectives; but the benefits of these changes would be negated by the continued imposition of military service retirement liability and restrictions on the Postal Service's access to the CSRS escrow account.

From the outset of this legislative process, the APWU expressed the view that the USPS was fundamentally sound, and that the reductions in volume and the increased debt in the aftermath of 9/11 and anthrax would be overcome with a stable economy. Current USPS statistics support that analysis. The sky has not fallen and the future is bright.

The Postal Service is Economically Viable at This Time

When I testified before this Committee in February 2004, I said the following:

> "The widespread support for postal 'reform' is based on the premise that the Postal Service is a failing institution – one that is at risk of entering a 'death spiral.' I believe it is premature to make a final determination on this matter. We must remember that postal volume continues to recover from the effects of several events – the terrorist attacks of 9/11, followed by the anthrax attack that took the lives of two postal workers.
>
> "These two events were superimposed over the recession that began in early 2001, from which we are only now experiencing a relatively weak and inconsistent recovery. If one were to extract the impact of technological diversion, these events standing alone would have had a serious impact on postal volume."

My point is that after the effects of 9/11, anthrax and recession are taken into account, who can say with any certainty what the effects of technological change have been?

As Richard Strasser, Chief Financial Officer of the USPS, recently reported to the Board of Governors:

- Total volume is expected to reach an all-time high in FY2005;
- Standard Mail will reach a new milestone, and is expected to grow nearly 10 percent this fiscal year;
- Priority Mail has grown after several years of decline;
- So far this year First-Class Mail volume is increasing this year for the first time in three years, and it is higher than USPS projections;
- Work hours have been reduced by 728 million over the past five years;
- Surpluses experienced in FY2003 and FY2004 total over $6 billion;
- Postal debt has declined virtually to zero; and
- There has been no rate increase for four years, and that streak can be extended through a fifth year if the military retirement obligation and escrow issues are correctly resolved.

These are not the statistics of a business model in need of major change.

The two principal obstacles facing the Postal Service are the military retirement liability and restrictions on access to the CSRS escrow account. Beyond solving these urgent problems, Congress must be careful not to tamper with a major success story. The postal business model is in much better condition than that of the federal government, which will incur the highest trade and fiscal debt in the history of civilization.

For the Postal Service, modest change – not a radical restructuring – is appropriate. Congress must do everything in its power to ensure that the change is positive, and benefits all of America's citizens.

The Proposed Legislation Threatens To Create Additional Problems

Increased rate flexibility would be beneficial to the Postal Service and the mailers. However, a rate cap that does not allow for unanticipated circumstances could cause serious harm and deny the USPS the flexibility needed in a dynamic environment.

A rate cap that prevents the USPS from "banking" savings when increases are below the cap would guarantee insufficient revenue over time, and ultimately would require cuts in service.

Placing single-piece parcel post in the competitive category of mail would destroy the Postal Service's capacity to provide this service, driving it from the market.

Granting an appointed Postal Regulatory Commission (PRC) unprecedented authority would relegate the Board of Governors and the Postmaster General to implementers of policy designed by others.

Imposing a waiting period for worker compensation eligibility is unfair and inhumane – especially in light of the risks postal workers continue to face as they process and deliver America's mail.

Final Decision

Your final decision on these issues will have a lasting impact on the mail service for every American.

This is the last public hearing before you convene in committee to consider this legislation. I close with the physicians' admonition: "First, do no harm."

Thank you for the opportunity to voice the concerns of postal workers.

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GROWING WITH AMERICA SINCE 1861

U.S. Senate Committee on Homeland Security and Governmental Affairs
April 14, 2005

U.S. Postal Service: What is Needed to Ensure its Future Viability?

American Forest & Paper Association
Statement for the Record

The American Forest & Paper Association (AF&PA) welcomes this opportunity to present its views on legislative initiatives to reform the United States Postal Service (USPS). Realizing that the success of the allied paper products industry and the USPS are inextricably linked, AF&PA has consistently supported measures intended to substantially reform and modernize the USPS. AF&PA supported the creation of the President's Commission on the United States Postal Service, welcomed its final report, and supported legislative measures in 2003 and 2004 aimed at strengthening the financial viability of the USPS. Our industry welcomes your committee's leadership on this issue and offers our assistance and perspective on legislative provisions to encourage the Postal Service to improve service, reduce costs, and respond to a changing marketplace.

AF&PA is the national trade association of the forest and paper industry and represents more than 240 member companies and related associations that engage in or represent the manufacturers of pulp, paper, paperboard and wood products. Today, the U.S. forest products industry is facing serious domestic and international challenges. In the past five years, 92 pulp and paper mills have closed in the U.S., resulting in a loss of 47,000 jobs, or 21% of our workforce.

The decline in paper mail volume processed through the Postal Service is one factor accounting for these losses. AF&PA and the allied paper products industry (composed of pulp, paper and paperboard mills as well as plants that convert primary paper into envelopes, stationery, and boxes) provide the raw materials for paper-based communications – much of which is transmitted via the Postal Service. More than 10 million tons of printing and writing paper – about a third of U.S. demand – is shipped through the USPS. However, the U.S. paper industry has shut down 7% of its printing and writing papers capacity since 2000. The amount of printing and writing paper purchased by our customers has a direct relationship to the volume of mail that moves through the USPS system. When the USPS raises rates, mail volume (especially demand for printing and writing paper) decreases significantly. In fact, the more the Postal Service has raised rates the more volume it has lost, creating a declining financial spiral and compounded difficulties for both the USPS and the paper products industry.

As you know, USPS leadership announced last week its intention to file a 5.4% rate increase case to take effect in early 2006, with the potential for further increases in coming years.

AF&PA economic research and the experiences of our member companies in recent years have demonstrated that increases in postal rates and decreases in mail shipments strongly correlate with corresponding shifts in demand for printing and writing paper. The 2006 rate case will have a significant negative impact on the allied paper products industry. AF&PA and its members, along with the 9% of the U.S. economy affected by USPS rates, appreciate Congressional efforts to lessen the impact of this postal rate increase. We welcome the opportunity to work with you to obtain legislation with the following provisions that will mitigate the size and scope of the expected 2006 rate increase, as well as ensure the financial viability of the USPS into the future.

ESCROW ACCOUNT REPEAL

We were pleased with the passage in 2003 of the Postal Civil Service Retirement Funding Reform Act (Public Law 108-18) and thank the Congress for its support and leadership in that effort. This law corrected the USPS liability to the Civil Service Retirement System (CSRS) and helped to forestall an unwise postal rate increase that would have occurred just as the economy was beginning to show signs of growth.

However, as you know, the law requires the USPS to maintain an escrow account containing funds estimated to fully fund retirement when deciding future rate adjustments. This escrow account provision will certainly force postal rates to increase unnecessarily and should be repealed. In 2006, the USPS will have a $3.1 billion liability to comply with the escrow account provision. Last week, USPS leadership announced that the sole intention for the expected funds to be obtained from the 2006 rate increase is to fund the escrow account requirement. This 5.4% increase, which will have a detrimental effect on the paper products industry, could potentially be rendered unnecessary with the repeal of the escrow account. AF&PA supports legislative measures that will repeal the escrow requirement and provide the dedicated funds to prevent, lessen, or delay the planned 2006 rate increase.

RESPONSIBILITY FOR MILITARY BENEFITS

AF&PA is also concerned with the requirement that the USPS fully and independently finance the pension benefits of its employees who served in the military. This policy will not only represent an undue financial strain on the USPS, but also contradicts the statement of the President's Commission that "taxpayers, not ratepayers, should finance military pensions." AF&PA agrees with this principle, and, therefore, believes that the responsibility for funding an estimated $27 billion in future CSRS payments relating to the military service of Postal Service retirees should be returned to the Department of the Treasury. The USPS should not be responsible for the CSRS costs based on prior military service of its employees if no other federal agencies faces the same requirement. Current policy is an undue financial strain on the USPS, and essentially results in postal ratepayers financing military pensions of Postal Service retirees. Shifting the responsibility of these benefits to the Treasury will free up significant funding to minimize the effect of the coming rate increase on our industry and others in the mailing community.

RATE STABILITY AND PREDICTABILITY

As stated above, postal rate increases have direct negative impacts on the paper products industry. We continue to support several reform initiatives that will increase efficiencies, reduce costs and maximize volume and revenue in the USPS. Cost cutting and efficiencies will best ensure the long-term financial viability of the Postal Service. However, if rate adjustments are absolutely necessary in the future, AF&PA strongly supports legislative initiatives that will help assure stability and predictability in the ratemaking process and permit businesses that depend on the postal service to build these potential cost increases into their business plans.

Specifically, AF&PA urges Congress to ensure that any rate increases are limited to a measure of inflation increase, such as the Consumer Price Index. There should also be a provision specifying a stringent exigency clause that would permit the USPS to only raising rates above the limit in unexpected and extraordinary circumstances. AF&PA also believes that postal rate increases should never occur more than once per year. These measures will enable the many industries that use paper products for mailing purposes to mitigate the cost increases in their business plans. In recent years we have seen large USPS rate increases in short time spans. These unpredictable rate increases wreak havoc on business planning and lead to instability in the mailing industry as well as lost volume in the postal system which in turn leads to higher costs and lower revenues. A more predictable ratemaking process will help businesses and the Postal Service by providing a better opportunity to plan for the rate increases.

WORKSHARING AND RIGHT-SIZING

AF&PA recognizes that the USPS faces numerous challenges regarding its current and future workforce. However, Congress has the opportunity through legislation to reform the postal workforce and obtain increased efficiencies and reduced costs so that the USPS is financial viable and competitive into the future.

A GAO study indicated that the USPS saved between $15 and $17 billion in 1999 through public/private worksharing in the mail processing and delivery systems. The President's Commission supported worksharing agreements as a viable efficiency tool for present and future USPS success. AF&PA urges Congress to authorize the expansion of the worksharing and private sector in which the USPS already participates. However, we oppose provisions that prevent worksharing discounts from exceed costs avoided. Such limits will prevent the USPS from recognizing the full benefits of worksharing.

The paper products industry has instituted many workplace efficiencies over recent years that have reduced operating expenses and permitted additional funding for employee incentive programs. The USPS should be permitted to institute, to the maximum extent possible, workplace efficiencies that have succeeded in the private sector in recent years. Congress should encourage initiatives that would grant the Postal Service the flexibility to pay competitive wages, measure job performance, and reward and penalize accordingly. Similar reforms in the private sector have reduced operating expenses and permitted additional funding for employee incentive programs, and may prove successful for the USPS as well.

AF&PA also supports giving the USPS the flexibility to right-size its workforce to meet the changing marketplace of today and the future. Nearly half of the current employees of the Postal Service will become eligible for retirement by the end of the decade. This natural attrition will permit the USPS to undergo a workforce reduction without a negative impact on most current employees.

WORKERS' COMPENSATION COSTS

AF&PA recognizes that one significant area in which the USPS could limit its current and future retiree costs is that of workers' compensation costs. In its 2004 annual report, the Postal Service claims that its total workers' compensation liability to be $7.6 billion. This cost, if left unchecked, could significantly damage the financial viability of the USPS now and in the future. The President's Commission indicated that the USPS liability for workers' compensation costs could be lessened with reforms that are largely accepted in the private business community. Several companies in our industry have employed management tools to mitigate considerable workers' compensation costs in recent years. AF&PA agrees with the President's Commission that the USPS should make similar reforms to deal with the liability. Imposing a three-day waiting period before the commencement of benefits, limiting the size of the benefits, and moving employees to retirement pay from worker's compensation pay at the appropriate age are all suitable measures of reform already in place in the private sector that will further secure the financial viability of the USPS.

Thank you again for this opportunity to offer the perspective of the paper products industry on the various postal reform legislative initiatives this year. AF&PA recognizes and appreciates the leadership provided by this committee and its House counterpart on this complex and multifaceted issue. The volume of associations, companies, and organizations interested in postal reform legislation testifies to its importance to the American economy.

AF&PA and its member companies know from experience that sudden and significant postal rate increases reduce mail volume, decreasing demand for our products, specifically printing and writing paper. The planned 2006 rate increase, as well as others expected in the next few years, will have a detrimental effect on the industry and its employees. Therefore, AF&PA strongly supports the reform initiatives mentioned above that will permit the USPS to reduce costs and more effectively manage its workforce in order mitigate the size and scope of the next rate increase, as well as lessen the impact of those in future.

For additional information, contact Donna Harman, 202-463-2476, or Brett Smith, 202-463-2792.

Post-Hearing Questions for the Record
Submitted to the Honorable Timothy S. Bitsberger
From Senator Tom Carper

"U.S. Postal Service: What is Needed to Ensure its Future Viability?"

April 14, 2005

1. **You contend that the Postal Service was recently forced to file a request for a 5.4 percent rate case, not because of the requirement that they begin depositing their approximately $3 billion annual pension savings into escrow next year, but because they haven't done a good enough since their last rate increase in 2002 to control costs. Based on my observation, however, General Potter and his team have done more over the past few years to take costs out of the system than at any time since the Postal Service was created. They've reduced their workforce, including management positions, improved productivity and, at a time when First Class mail continues to decline, they've almost eliminated debt and turned a small profit. At the same time, postal employees have seen very modest pay increases. I certainly agree that more could be done to control costs at the Postal Service but, at a certain point, won't those efforts have an impact on service? Give us some examples of what you think the General Potter could cut without also weakening service.**

1. The question raises several important issues:

   a. The escrow is not a new cost to be recovered. These cash flows result from all previous rate cases, with the last completed case filed in 2001. P.L. 108-18 allowed the Postal Service to use these cash flows for three years before they were to be escrowed. This action effectively provided a three-year holiday from these payments before these funds, which were and are already in rates, would be escrowed. The escrow provides an opportunity for the Postal Service to fund its massive unfunded liabilities in a responsible manner that reduces the rate shock that will otherwise face future ratepayers.

   b. The Postal Service has not had a rate case since 2001, and no rate increase since 2002. As acknowledged in the Postmaster General's testimony during the same hearing, the Postal Service has a statutory mandate to cover its costs through its rates. With $75 billion of unfunded liabilities, the Postal Service has in fact not covered its costs, either cumulatively or in any given year. Excluding these massive unfunded liabilities, the Postal Service's operating costs are higher today (and will be even higher in 2006) than they were in 2002.

   The following table provides insight into the Postal Service's most significant cost component, personnel. The information is based on the Postal Service's annual reports and the information filed with the Postal Rate Commission. The table demonstrates that the Postal Service's personnel costs in 2006 will be over

$7 billion higher than they were in 2002, which is substantially higher than the rate increase that the Postal Service is seeking.

Year	Personnel Costs[12] ($ billions)	Cost Increase over Previous Year ($ billions)	Cumulative Cost Increase Since Last Completed Rate Case ($ billions)
2001	$51.35		
2002	$51.56	$0.21	
2003	$53.93	$2.37	$2.37
2004	$55.63	$1.71	$4.08
2005	$57.39	$1.75	$5.83
2006	$58.58	$1.19	$7.02

The Postal Service has also seen a significant increase in fuel costs, which based on our discussions with the Postal Service are largely pass-through costs that it is responsible for. If one looks at the futures markets for crude oil in September 2001 (when the Postal Service filed its 2001 rate case) and again on April 4, 2005 (four days before Postal Service filed its 2005 rate case), we see that the Postal Service's 2006 costs will have increased by over $700 million using its estimate of 800 million gallons of fuel consumption annually.

The personnel costs that the Postal Service does recognize in any given year (it does not recognize the accrued post-retirement health liability) and the additional fuel cost over 2002 represent $7.7 billion in costs that the Postal Service is not seeking to cover through the 2005 rate case. It is interesting to contrast the 2005 rate case 5.4% price increase with the cumulative to-date CPI since the implementation of the 2002 rate increase. The cumulative increase in CPI since 2002 is 12.4% and this does not consider what will happen during the remainder of 2005 and 2006.

c. GAO and the Administration have focused considerable attention over the past three years on the issue of the Postal Service's post-retirement health liabilities. Yet, despite the attention, personnel costs included in the rate base (including those in the recently filed 2005 rate case) continue to ignore the post-retirement health costs that employees accrue each year for their service in that particular year. Ignoring the newly accrued post-retirement health costs for each year (costs that should have been paid for by ratepayers in that period) exacerbates the Postal Service's massive unfunded liabilities. These liabilities threaten future ratepayers with unconscionable rate shocks.

[1] To allow for an equal and proper comparison, for 2003 and each year thereafter, the initial benefit of P.L. 108-18 of $3.5 billion is added back to personnel costs. The Administration's plan changes the designation of these funds from "CSRS" to "Post-Retirement Health".
[2] These numbers do not reflect the accrued post-retirement health expense earned in each year.

d. As of the end of the 2004 Fiscal Year, the Postal Service had 807,596 employees which is a decrease of 46,780 over 2002, yet personnel costs have increased by $4 billion in the same period. With between 30,000 and 40,000 employees leaving the Postal Service annually the results to date, while admirable, indicate that more can be done. Over the next five years, about half of the Postal employees are eligible to retire. The Postal Service needs to take advantage of this opportunity to optimize its use of labor. This also provides the Postal Service with the opportunity to focus on productivity gains comparable to the private sector. While we applaud the recent positive gains in productivity, we are mindful that productivity at the Postal Service has significantly trailed the private sector in each recent year as well as cumulatively since reorganization.

e. The Postmaster General's testimony for this hearing highlights that since 2001 the Postal Service has "a cumulative $8.8 billion reduction in costs since 2001". We commend the Postal Service for these reductions but note that this represents just 3.3% of the $265.3 billion of expenses incurred during the 2001-2004 period. It is reasonable to expect greater reductions in the future.

f. We do not believe that a smaller workforce must be accompanied by decreased service quality. Indeed, service is integral to what mailers are paying for. We are confident that the Postal Service will work very closely with its customers to ensure that its service meets their expectations. The private sector provides numerous examples, including "network" businesses, where personnel and costs are removed without decreased service levels. Productivity improvements will also help improve service quality. We expect that productivity will be driven by prudent and skillful management, improved labor-management relations, and increased use of technology. Additionally, based on a large number of meetings that we have had with stakeholders over the past 3-½ years, we believe that a Postal Service that partners effectively with its customers will create opportunities to become more efficient and productive. Finally, as has been frequently mentioned by the Postal Service, processing and distribution network optimization provides significant opportunities for the Postal Service to reduce its cost structure. According to the Postal Rate Commission the Postal Service spends over $26.3 billion on its network. While we have heard a variety of estimates from the Postal Service and stakeholders regarding the size of potential savings, we are convinced that network optimization provides significant opportunity for annual cost reductions.

2. **As you know, the Postal Service must deliver to between 1.6 million and 1.9 million new addresses each year. At the same time, First Class mail is on the decline. Standard mail is growing for now but Standard letters don't cover the same percentage of the Postal Service's costs as First Class letters do. In addition, it's probably inevitable that Standard mail will one day be replaced by electronic communication as well. This means more and more letter carriers will be bringing fewer and fewer letters each day to a continually growing number of homes and businesses. Under this scenario, how long will it be realistic to keep postal rated within the kind of tight, CPI-based cap we have in S. 662? Should the cap be revisited from time to time?**

2. The question raises several important issues:

    a. Gaining 1.9 million new customers annually is a good and profitable "problem" to have. These new addresses are generally in growing and more affluent areas that receive more mail than the average postal customer. New addresses typically use "cluster-boxes" or curb-side delivery which is more efficient than "park-and-loop" delivery (which is often used in older parts of cities). They also tend to be on routes covered by rural and contract carriers, which are generally more productive and less expensive than the city carriers. In 2003, the Postal Rate Commission provided the Board of Governors with an analysis that showed the 1.9 million new addresses cost the Postal Service $176 million, or $92.20 per delivery point. The average revenue per delivery point (which understates what the new delivery points generate because of the demographics discussed above), in 2003 was $463.16 per delivery point. Therefore, the new addresses generated $880 million in revenue, leaving a net profit of $704 million. Even if one accepts the Postal Service's higher cost estimate of $400 million, the new addresses would still generate a profit of $480 million. Similar to other "network" businesses, more customers are good because they enhance the value of the network.

    b. The full effects of electronic diversion are unclear. The Postal Service has gone through many technology changes over its existence, including the telephone, fax, computers and e-mail. Yet there remains value in the mail stream to mailers. Requiring the Postal Service to operate as a business, in a business-like manner, should drive management focus on ensuring that mailers continue to see value in the mail stream. This requires the Postal Service to work more closely and collaboratively with mailers, which we believe a properly motivated and accountable Postal Service will successfully do. We expect that a Postal Service with the flexibility to set prices, provide worksharing discounts, and enter into negotiated service agreements will work closely with its customers to ensure that it provides value to its customers. The Postal Service is not unique among businesses that face changing technology and changing markets. There are many firms in the private sector that have successfully addressed technological and market changes without the advantage of a monopoly, and we believe that our priorities will help the Postal Service address the ones that they face today, and will face in the future.

c. Regarding the rate cap, the analysis in part a above shows that the Postal Service will be better able to operate within CPI as the number of new addresses grows. Additionally, we have focused on reform elements that provide management with the flexibility to operate as a business, within the constraints of a rate cap. The rate cap gives senior management the right incentives to manage effectively and drive greater board and line management accountability, which is an important principle for the Administration.

We also believe it is important for ratepayers to have confidence that rate increases will be reasonable and predictable, and that the Postal Service has the right incentives to run this business as a business. Establishing a regular review of the CPI cap undermines both. In our discussions with ratepayers, we have heard loud and clear that they seek reasonable and predictable rate increases as a way to better plan their business and that this will help them to be a better customer of the Postal Service. In considering a periodic review of the CPI cap, we do not see this as providing the Postal Service with the appropriate incentives to reduce its costs and improve its productivity and efficiency. The Postal Service will come to believe that the CPI cap is not binding, but is instead negotiable.

Any periodic review by the Postal Rate Commission should be focused solely on whether a modifier, such as a productivity factor, should be considered to reduce the CPI rate cap.

3. In your testimony, you acknowledge that First Class mail volume is on the decline and isn't likely to roar back. At the same time, however, you say that the Postal Service is capable of finding and developing new streams of mail to make up for the loss of First Class volume. Where will this mail come from? How can it make up for the loss of First Class mail?

3. The full effects of electronic diversion are unclear. The Postal Service has gone through many technology changes over its existence, including the telephone, fax, computers and e-mail. Yet there remains value in the mail stream to mailers. Requiring the Postal Service to operate as a business, in a business-like manner, should drive management focus on ensuring that mailers continue to see value in the mail stream. This requires the Postal Service to work more closely and collaboratively with mailers, which we believe a properly motivated and accountable Postal Service will successfully do. We expect that a Postal Service with the flexibility to set prices, provide worksharing discounts, and enter into negotiated service agreements will work closely with its customers to ensure that it provides value to its customers. The Postal Service is not unique among businesses that face changing technology and changing markets. There are many firms in the private sector that have successfully addressed technological and market changes without the advantage of a monopoly, and we believe that our priorities will help the Postal Service address the ones that they face today, and will face in the future.