POSTAL TRENDWATCH

The Lexington Institute
1600 Wilson Boulevard, Ste. 900
Arlington, VA 22209
703-522-5828
www.lexingtoninstitute.org
Postal TrendWatch
Q1FY12

Q1 FY 2012: Monopoly Service to Worsen, Competitive Service to Improve?

Executive Summary

The United States Postal Service (USPS) suffered a net loss of $3.3 billion in the first quarter of FY 2012 -- approximately $3 billion more than it lost in the same period last year.

USPS attributes much of this loss to the near doubling of retiree health benefit expenses in this quarter, relative to Q1 FY 2011. Operating revenue declined by $200 million relative to Q1 FY 2011. Overall mail volume dropped 6 percent, despite significant growth in Shipping Services volume.

USPS says that it will likely be unable to make $5.5-billion and $5.6-billion retiree health benefit prefunding payments, which are due August 1 and September 30, respectively. The former payment has already been postponed from September 30, 2011. It is currently making both payments in monthly installments over the course of the fiscal year. Even if Congress were to delay or eliminate these prefunding payments, the agency would reach its borrowing limit in October 2012.

USPS claims to have identified $20 billion in potential cost savings over the next three years that would be achievable through reforms to its mail processing, delivery, and retail networks.

Packages Shift During Flight to Competitive Designation

First Class Mail revenue dropped 4.1 percent in Q1 FY 2012 compared to the same period last year; the corresponding volume decreased 4.7 percent. Standard Mail fared even worse, with revenue and volume declines of 6.1 percent and 7.5 percent, respectively. Overall, volume for the two categories, which represents 95 percent of USPS's total, decreased 6.2 percent.

Meanwhile, Shipping Services revenue, including that for newly re-classified First Class Package Services, shot up 14.9 percent, to more than $2.9 billion this quarter. Corresponding volume was up by a third. Excluding this new addition to the Shipping Services category, revenue was still up 6.9 percent. But as USPS points out, "because Shipping Services represents approximately 17 percent of our total revenues, these increases cannot fully offset the declines in First-Class Mail revenue."

USPS attributed the boom in Shipping Services to strong retail e-commerce spending, which was up 15 percent for the entire 2011 holiday season, according to ShopperTrak.

The agency also benefited from more returns of online merchandise. The National Retail Federation pegged returns as up 4 percent. USPS has identified this market as a target area for growth. USPS Chief Marketing Officer Paul Vogel has said, "At the end of the day, returns is what is going to keep USPS a vibrant business."

The re-classification of First Class Packages as Competitive Products gives the Postal Service more control over its price because monopoly products have statutory limitations on price increases. But it also raises concerns about whether postal management is subsidizing its pricing with revenues from monopoly products. *(Continued on next page)*

According to the 2009 Household Diary Study, the number of First Class Packages sent and received by households steadily increased, by 53 percent, between 2007 and 2009. In contrast, total Shipping Services volume -- prior to the inclusion of First Class Packages, of course -- increased just 2 percent during the same time period.

In other words, the Postal Service appears to have shifted the one category within its monopoly portfolio that was growing substantially -- First Class Packages -- onto the competitive side of the ledger. It is unclear what future implications this move may hold for other First Class products, whose customers may now be required to shoulder greater overhead costs.

Reduced Service Standards: The USPS Saves, But Who Pays?

In December 2011, Postmaster General Patrick Donahoe proposed a reduction in service standards that would reportedly save the Service $3 billion annually, or less than 5 percent of annual expenditures. This reduction is part of a larger plan to reduce operating costs by $20 billion by 2015.

Under Donahoe's plan, First Class Mail delivery would be slowed, and next-day delivery of First Class letters would be eliminated.

These service quality cuts will not apply for competitive products, like Priority and Express Mail.

First Class Mail already contributes four times as much revenue as a percentage of its costs toward overhead than does Priority Mail. A reduction in First Class service standards would force monopoly consumers to shoulder more of the Service's cost burden.

USPS Spends More on Private-Sector Suppliers

USPS spent more than $6.8 billion on private-sector suppliers in 2011, according to David Hendel of Husch Blackwell LLP. That's almost $100 million more than the agency spent in 2010 -- but $600 million less than it spent during 2009.

FedEx was once again the top contractor, taking in nearly $1.5 billion to transport Express, Priority, and some First Class Mail for the Postal Service. The 2011 total represented a $120 million increase over its 2010 level. FedEx was the only supplier to receive more than a billion dollars from USPS -- and did so for a third consecutive year.

The second-place supplier, Kalitta Air, trailed FedEx by almost $950 million. Kalitta carries military mail to Iraq and Afghanistan.

Consulting firm Accenture found itself among the top ten suppliers for the third year in a row, with Postal Service revenues of more than $125 million -- $10 million more than last year but nearly $40 million less than two years ago. Accenture provides technology and consulting services to USPS across three areas: "professional services, enterprise-wide business solution development, and . . . virtual development centers."

IBM was also in the top ten for a third consecutive year, with postal revenues of more than $108 million. IBM offers "business consulting services, mail transit time measurement, and software services" to the agency.

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"Bold action is needed to ensure that USPS can continue to operate in the short run and achieve viability in the long run."

- White House FY 2013 Budget Request

In total, 11 suppliers had USPS revenues each in excess of $100 million -- the same as last year and four fewer than in 2009.

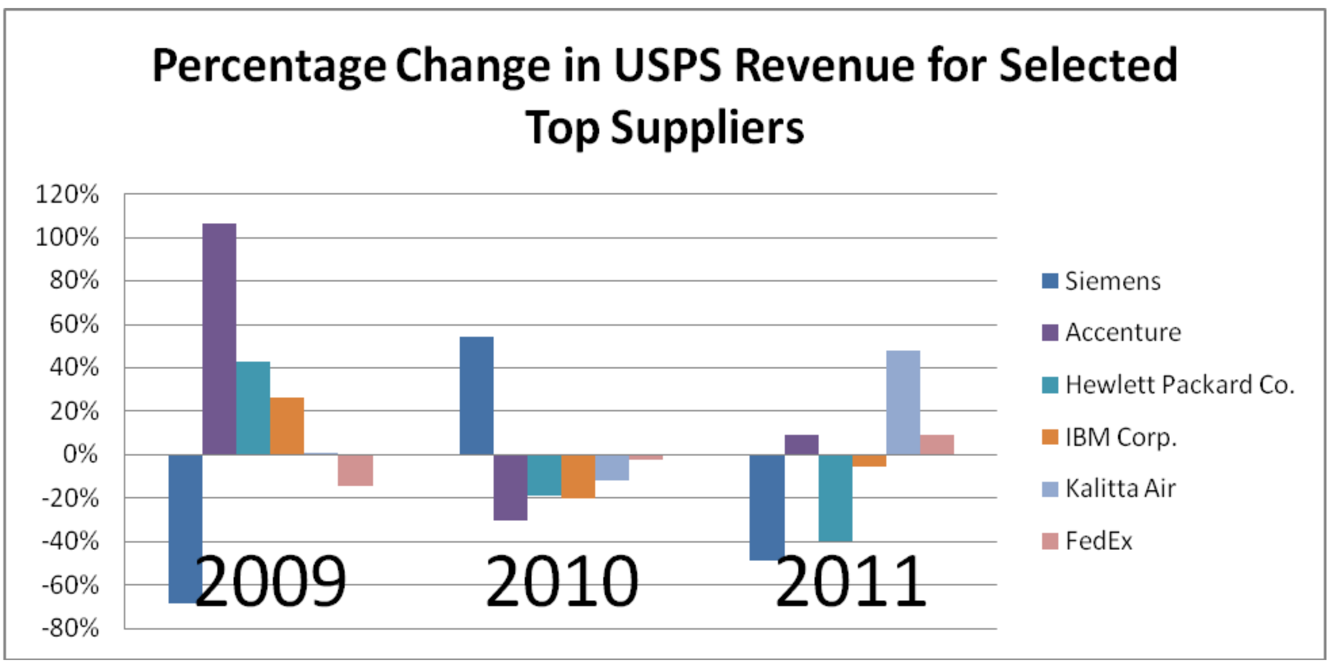
Kalitta saw its USPS revenues jump nearly 48 percent in 2011. Among the remaining top ten suppliers, revenues for Mail Contractors of America (MCA) and United Airlines increased by 11 percent and 18 percent, respectively. MCA provides ground transportation of mail for USPS, primarily long-haul trucking. United Airlines transports mail by air.

Among the top 20 suppliers, Siemens's revenues from the agency took the largest hit -- nearly 49 percent, as the firm dropped from fifth to 20th place. Hewlett-Packard also suffered a nearly 40 percent reduction in postal revenues, falling from sixth to 15th place. Siemens supplies sorting equipment, including bar-code readers, while HP provides technological equipment including servers and desktop and laptop computers. 2011 represented the final year of HP's five-year contract with USPS, and observers expect a new contract to be awarded to the winning supplier in April.

New Postal Services through Lockers?

One new experimental product offering by the Postal Service is raising eyebrows by reinventing the post office box with features previously unique to products offered by private-sector competitors. Late in Q1 FY 2012, USPS began trials for parcel collection and delivery lockers in Northern Virginia. Customers could visit these "GoPost"-branded lockers to drop off pre-paid packages for delivery or to pick up packages destined for them at all hours of the day or night. The Postal Service is also experimenting with allowing owners of these boxes to use street addresses, which could ultimately allow access by private delivery companies.

Posts in several countries – most notably Germany – have launched similar services. Amazon offers a similar locker in grocery stores in Seattle and New York as an option for receiving its packages.



Source: Husch Blackwell LLP