POSTAL TRENDWATCH

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Postal TrendWatch
Q4, FY07

Q4: The First Full Quarter under the New Rate Structure

Executive Summary

As of September 30, 2007, the Postal Service completed its first full quarter operating under its new rate structure, which was implemented on May 14, 2007. In a continuation of previous trends, First Class Mail volume declined, while Standard Mail volume increased.

Meanwhile, USPS's year-end reports revealed significant financial setbacks, which the Service attributed to benefit-funding requirements of the Postal Accountability and Enhancement Act. Given the 10-year duration of those funding requirements, this problem is likely to continue. As a result, the Postal Service will need to continue increasing productivity and cutting costs to meet this requirement under the law's new rate-cap provisions.

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Overview

With the end of Q4, the U.S. Postal Service completed its first full quarter under a new rate structure approved in May. The comprehensive reforms passed in late 2006 under the Postal Accountability and Enhancement Act (PAEA) continue to be implemented. One thing that's clear is that volumes are falling across the board, with the sole exception of Standard Mail. At the same time, both revenues and overall operating expenses have continued to rise. This counter-intuitive trend -- of falling volumes coupled with rising expenses and revenues – characterized the final quarter of FY07.

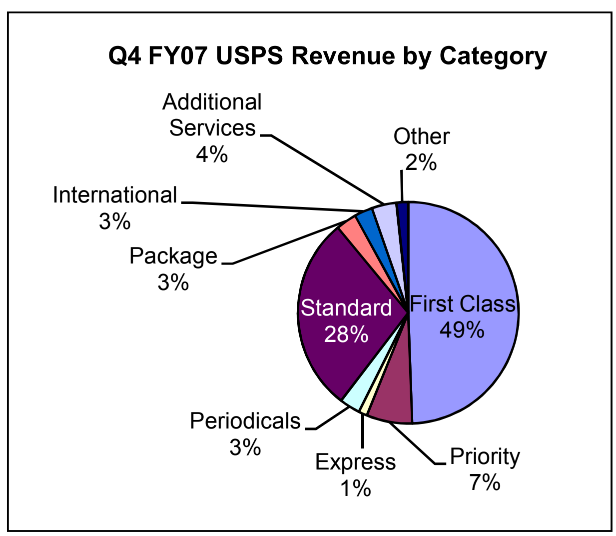
Declining Mail Volume -- Except for Standard Mail

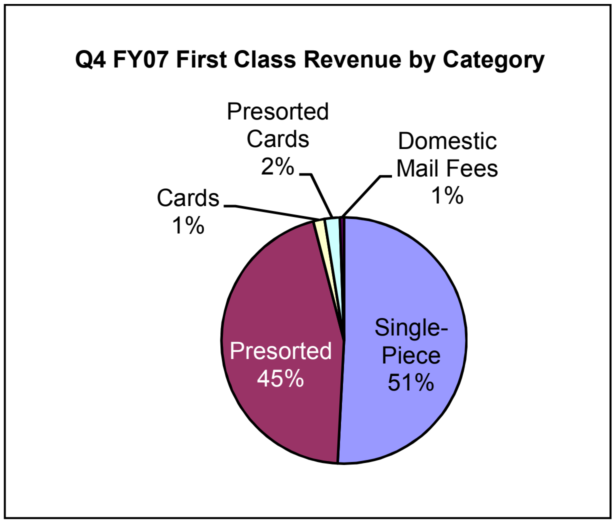
During Q4, First Class Mail volume continued to decline, falling 4.4% relative to the preceding three months and 2.6% from the fourth quarter of 2006.

By contrast, First Class revenue rose 3.1% in Q4 compared to Q4 2006. First Class revenue fell 1.9% compared to the previous quarter thanks to the May rate increase.

However, in a significant departure from past trends, First Class Mail provided less than 50% of all USPS revenue during the fourth quarter. Normally, First Class Mail provides at least half of the Service's income, usually slightly more. It remains to be seen whether this new trend of declining First Class revenue shares will continue.

Meanwhile, Standard Mail exhibited strong growth in both revenue and volume. For the whole of FY07, Standard Mail volume was up a respectable 1.0% over the 2006 total.





Revenue from Standard Mail increased 5.3% over Q4 2006 and 4.5% year-on-year. Despite this surge, Standard Mail lagged behind First Class Mail in terms of overall revenue.

Mail volume also declined in other classes. Priority Mail, Express Mail, and Periodicals all experienced a drop in volume relative to both Q3 and Q4 2006.

However, as volumes fell, revenues in all classes continued to rise, thanks primarily to the May rate increase.

With volume declines across virtually all sectors of mail except Standard, it is becoming increasingly apparent that Standard Mail represents the best long-term volume growth opportunity for the Postal Service. As the Postal Service noted in its 2007 Comprehensive Statement on Postal Operations, "Standard mail volume growth was aided considerably by the increasing strength of direct marketing channels and surges in credit card

Year-End Finances: PAEA to Blame?

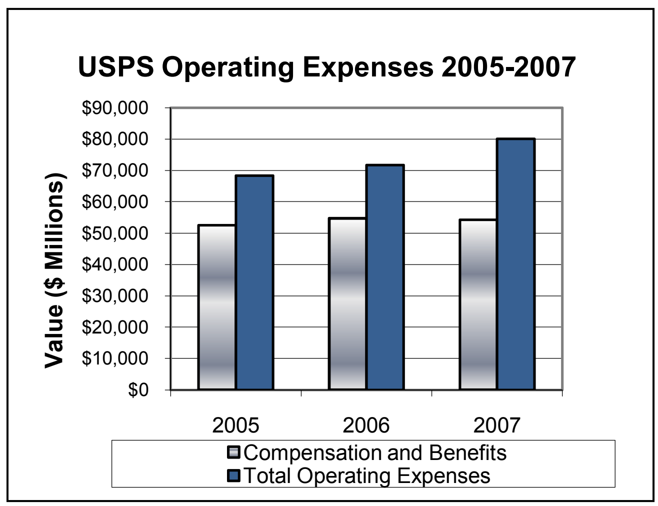
For FY07, USPS announced a net loss of $5.1 billion. The Postal Service attributed the loss to a "negative financial impact" from the Postal Accountability and Enhancement Act.

Under PAEA, USPS is now required to make regular payments into an escrow fund that will be used primarily to pay health care benefits for future retirees. This fiscal year's tab: $5.4 billion.

These escrow payments will continue for the next 10 years. It's clear that USPS will be unable to meet this long-term requirement without a combination of revenue gains, productivity increases, and cost-cutting measures.

Management's plan for 2008 counts on significant cost controls and productivity gains. Expenses are predicted to be $78.8 billion -- 2.0% lower than those in 2007. Total factor productivity (TFP) is also expected to improve by 1.0% in the upcoming fiscal year.

TFP has grown for nine consecutive years, but some observers have suggested that new productivity gains will be harder to come by. In the current environment, it is clear that increasing TFP will require additional cost-cutting.



As the chart above shows, labor costs still comprise the bulk of operating expenses. Total compensation has declined slightly from 2006, but remains higher than it was in 2005. Meanwhile, overall operating costs are steadily rising, which threatens to eat up any small gains in productivity. Maintaining the Postal Service's long-term fiscal health will clearly require additional cost reductions -- especially given the trend of declining mail volumes.

According to Plan

Postmaster General John E. Potter and other USPS leaders have consistently emphasized the importance of adhering to each fiscal year's Integrated Financial Plan. For example, at a November meeting of the Board of Governors, Potter noted that USPS revenues had already fallen $300 million "below plan" for the first month of FY08.

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With such concerns in mind, how did USPS perform relative to its plan for FY07?

Not as well as "planned," but within reason. In its plan, USPS predicted a net operating income of $1.7 billion. In reality, it fell short, netting only $1.5 billion.

First Class revenue exceeded the forecast by nearly $300 million, while Standard Mail fell nearly $700 million short.

First Class Mail again exceeded expectations in terms of volume, which declined by about a billion pieces less than anticipated. Standard Mail, on the other hand, fell short of predictions by over a billion pieces.

Both overall volume and revenue – while falling slightly short – were within 1 percent of the Postal Service's respective targets for FY07.

In terms of productivity, the FY07 plan aimed to reduce workhours by 40 million from the 2006 level. USPS missed this goal by 10%, achieving only a 36-million workhour reduction. Rural delivery bucked the trend of generally declining workhour levels, increasing by 3 million in 2007.

The Lexington Institute's Postal TrendWatch will continue analyzing USPS reports to determine the interaction between volume, rate increases, and productivity in what remains the U.S. government's largest employer.