POSTAL TRENDWATCH

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Postal TrendWatch
Q3, FY 2007

Q3: Can Rising Productivity Sustain Falling Volume?

Executive Summary

The Postal Service experienced both revenue and volume growth in the first three quarters of FY 2007. However, overall volume growth appears to be slowing. In particular, First Class Mail continued its historic decline.

The big question that remains is whether the strong growth in productivity and Standard Mail can fill the gap left by shrinking First Class Mail.

Also, after six years of uninterrupted productivity growth, has the Postal Service finally reached a limit to wringing out more productivity gains?

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Overview:

The U.S. Postal Service is currently in the midst of changes rivaling those made following the Postal Reorganization Act of 1970, when the entire agency was subjected to a wide-ranging reorganization. The comprehensive reforms passed in 2006 are still being implemented and it's too early to know exactly how these additional changes will affect the service's long-term financial viability.

Over the last decade, there have been five rate increases on First Class Mail. The last hike went into effect in May -- in the middle of Q3. That mid-quarter change complicates analysis of the third quarter. It is still too early to assess the full impact of the rate hike. But some trends are emerging that will have far-reaching consequences for the Postal Service's finances as well as future volume.

Whither First Class Mail?

During Q3, First Class Mail volume continued its historic decline, dipping 1.3% against Q3 of FY 2006. Despite the downturn in the mail volume, First Class revenue rose a modest 1.7% during Q3 compared to Q3 of FY 2006. Although First Class Mail continues to account for less than half of all mail delivered, it still contributes over half of total Postal Service revenue.

These volume and revenue trends in First Class mail are consistent with recent years. This counter-intuitive trend of falling volume coupled with rising revenues is likely due to a multitude of factors, but two stand out. Obviously, for Q3 at least, the recent rate increase played a role, following on the increase which occurred two years ago. Another factor is the savings that have resulted from increased Postal Service productivity -- savings which allow the agency to reduce labor costs and gain more flexibility to adapt to market conditions.

It has long been predicted that USPS could not survive the discernible downward trend in First Class Mail volume as a self-supporting entity due to its own rising rates and the surge in electronic communications. First Class Mail has been the financial core of the agency since its inception. The argument ran that a falloff in volume could only be offset by increases in postal rates. Those increases would in turn further depress use of paper mail with the result that, ultimately, USPS revenues would fall to a level that made the agency inoperable without subsidies.

It is therefore noteworthy that -- so far -- Postal Service management has found ways to keep the agency financially afloat.

If some final "tipping point" hangs over the current Postal Service model, it has yet to be approached.

Can Standard Mail Fill the Breach?

In contrast to the Q3 decline in First Class volume, Standard Mail continues to grow. But Standard Mail is offered at discount, with substantial costs passed off in “work-sharing agreements," under which commercial clients preprocess, sort, and even transport an increasing proportion of Standard Bulk Mail.

As a result, the higher volume of Standard Mail contributes less to USPS revenues than does First Class. Nevertheless, a Postal Service geared to ever more efficient processing of Standard Mail will be much better positioned to deal with an eventual decline in First Class revenues.

For the first three quarters of FY 2007, Standard Mail volume was up 1.8% against the corresponding period in 2006. Revenue in this category grew an aggressive 4.3% over the same period.

Standard Mail volume was greater than First Class volume in both Q3 and the first three quarters of FY 2007, but revenue for Standard Mail was approximately half that of First Class Mail during these periods.

Productivity Up, But for How Long?

Productivity growth is crucial to the financial health of the Postal Service. Fortunately, over the past several years, wide-ranging initiatives put in place by current Postmaster General John Potter have resulted in substantial savings. Indeed, the USPS appears to be in the midst of a “golden age” of productivity growth, according to Michael Schuyler at the Institute for Research on the Economics of Taxation. The Postal Service has returned to its core business of delivering mail, increased automation, reduced its workforce through attrition, and introduced more efficient distribution of existing resources.

The Postal Service is a government agency exempt from many private-sector requirements, yet it is burdened by public-service mandates, considerable regulation and political oversight. So it is difficult to compare USPS productivity to that of the private sector. Still, a sophisticated productivity model -- “total factor productivity” -- shows that the USPS has achieved respectable increases in productivity when compared to the private sector.

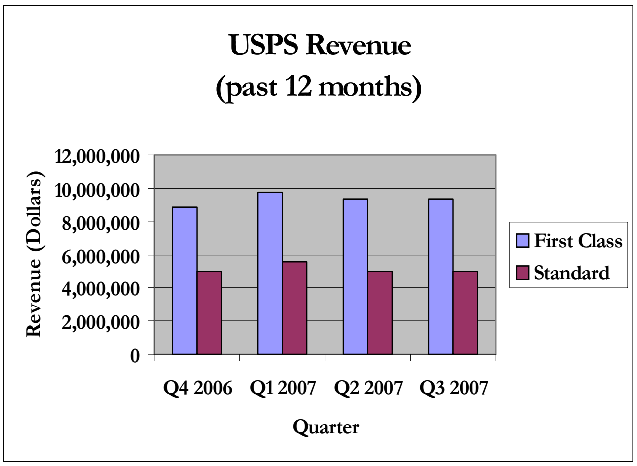
"Positive productivity numbers are not reason enough for Postal Service management to relax and declare fiscal victory"

According to TFP, the USPS has enjoyed six years of uninterrupted average annual total factor productivity growth of 1.5% -- a substantial improvement from the annual average from the previous 25 years of 0.2%. Those 1.5% increases still lag behind those achieved by the private sector -- but not by much. Private sector productivity growth came in at an annual average of about 1.6% over the same period.

In large part, these increases in Postal Service productivity can be attributed to increased use of labor-saving machines (like the 300,000 Intelligent Mail Devices installed in 2006 and the 560 Automated Flat Sorting Machines installed in the last year); an increased use of information technology; and an increased use of work-sharing agreements to outsource sorting and processing functions to bulk mailers and other outside groups. On the other hand, despite investments in labor-saving machinery and practices, Postal Service labor costs continue to hover around 80% of total costs.

Michael Schuyler has calculated that, were it not for these increases in USPS productivity in the early part of this decade, some 9% more resources would have been required to meet the service's current workload. That 9% "gap" would have meant a First Class stamp price in the range of 44 or 45 cents, according to Schuyler.

Former chief economist for the Postal Service Charles



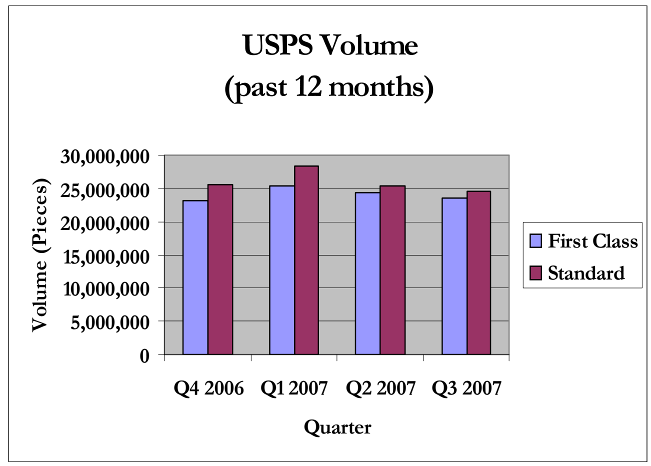
Guy, however, is less enthused about the agency's productivity numbers. Given the decline in First Class Mail volume, substantial productivity growth is absolutely essential to the Postal Service's fiscal health, absent presumably unpopular rate increases. "Positive productivity numbers are not reason enough for Postal Service management to relax and declare fiscal victory," according to Guy.

"The multimillion-dollar capital investments of the past two decades have yet to produce the economic returns promised." Further, Guy argues that the only way to evaluate accurately total factor productivity gains over the long term is to incorporate them into budget requests -- not to treat them as year-end bonuses that paper over managerial mistakes.

In any event, a continuation of productivity increases may no longer be possible in a leaner Postal Service. Productivity grew only 0.6% in 2006. So we may be reaching a limit to wringing more productivity out of the current business model.

Conclusion:

Taking all mail categories into account, USPS revenue through Q3 FY 2007 was up 2.2% over the corresponding period last year, and overall volume inched up 0.2%. In Q3 alone, revenues were up 2.4% while volume declined 1.3% over the same period of FY 2006.



These numbers bear out the broader trend of a slow decline in First Class Mail volume. What's less certain is if that decline will ultimately drag revenues down, as well. If it does, will USPS be able to fill the breach through more efficient Standard mail and sustained productivity gains?

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.