Dr. Michael J. Riley's Testimony Before the Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia

May 12, 2010

Mr. Chairman and members of the Committee, thank you for inviting me to testify. And thank you for holding these hearings on work-share discounts. Work-share discounts are a very significant, but too little understood, part of the ongoing debate about the financial welfare of the United States Postal Service. From 1993 to 1998, I served as Senior Vice President and Chief Financial Officer (CFO) of the Postal Service. That service gave me knowledge and insight that I hope will be useful to you as you consider work-share discounts. I am a Professor of Business and Executive Programs at the University of Maryland University College, and I also have my own consulting company. In addition, I serve on the board of directors of Church Mutual Insurance Company and as chairman of its audit committee. I served as chairman of the audit committee of the Architect of the Capitol from 2003 to March 2010. My experience also includes service as CFO of Lee Enterprises, CFO of United Airlines, and Treasurer of Michigan Bell Telephone Company. I have appended a brief biography to this testimony for your reference.

I am providing this testimony because I care about the Postal Service as an institution, I care about postal employees, and I care about postal customers. Focusing first on the topic of today's hearings, I recommend that Congress stick to the requirement, already in law, that postal work-share discounts may not exceed the costs that the work-sharing activity saves the Postal Service. Recent actions by the Postal Service that violate that standard are misguided and are damaging the institution by depriving it of much needed revenue and, more importantly, money needed to cover fixed costs. Efforts by the Postal Service and large mailers to separate work-shared mail from other First Class letter mail in order to increase their work-share discounts should be rejected.

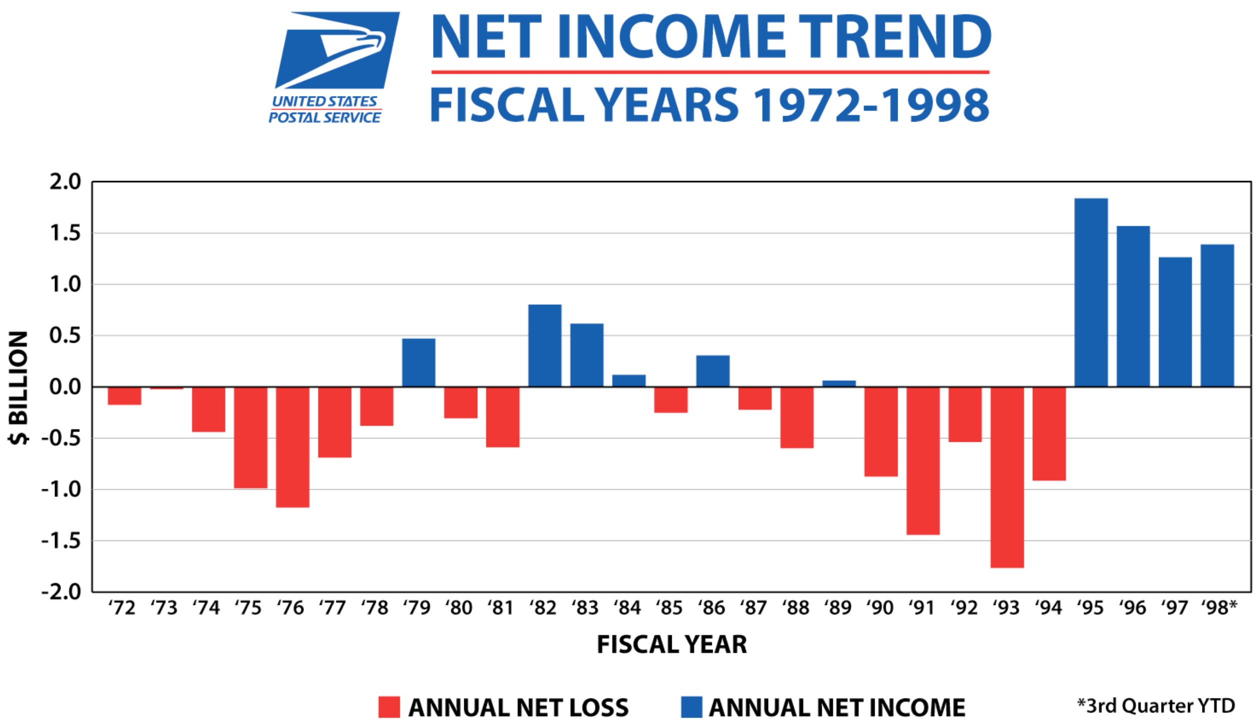
I would be remiss if I did not also comment on two related postal issues while I have this opportunity. The first is the Postal Service's proposal to largely eliminate Saturday mail delivery. This is a misguided and damaging proposal. This is the result of the failure of the Postal Service to price its products correctly and a miscalculation of the damaging effects of cost cutting measures on the ultimate customer, the individual receiving the mail. This proposal will exacerbate the trend toward electronic substitution for the mail. The Postal Service should be increasing and improving the services it offers not reducing them. The Postal Service is, quite literally, selling itself short. That strategy could prove to be the blow that may destroy any hope for future financial viability.

The second issue I must mention is the burden created by the advance funding requirement for retiree health benefits. This is not the place nor the time to engage in an extended discussion of that issue. Still, I strongly recommend that Congress repeal that requirement. The Postal Service should operate in the same way as other large employers in the way it provides for retiree health benefits. Typically, companies pay for retiree health benefits as the costs are incurred, rather than paying them in advance as the Postal Service is required to do.

In addition, it is my recommendation that the Postal Service should be structured similar to a mutual savings and loan or mutual insurance company. This would allow the Postal Service to accumulate profits as surplus to provide cash for new vehicles, equipment, buildings, new products and services, and to have a cushion to weather economic downturns. The law requires the Postal Service to break even over time. This means that a significant recession, such as the one we're in, threatens the financial viability of the Postal Service.

Background

At the end of the 3rd quarter in fiscal year 1998, the Postal Service reported a year-to-date profit of $1.4 billion, improved customer satisfaction, and higher employee morale. Four years of billion dollar profits had allowed the Postal Service to pay off $4 billion in debt and to triple capital spending. A graph showing the financial history of the Postal Service through the 3rd quarter of fiscal year 1998 is provided below.



As is shown above, the profits from financial year 1995 through 3rd quarter 1998 totaled $6 billion. These profits were used as capital to build post offices in new communities and to make major investments in equipment that improved accuracy and reduced costs. Despite a ten-year explosion of Internet use, mail volume rose nicely and the Postal Service was able to maintain the 32-cent price of stamps for four consecutive years.

The strategy was based on the Balanced Scorecard Model with equal emphasis on the customer, the employee, and the financial viability of the Postal Service. There was recognition that convenience, courtesy, safety, security of the mail, trust, consistency, and price were essential parts of the value mix. The primary customer was the individual. It was and is the preference and the response of the individual to mailings that drives mail volume. E-mail and electronic bill paying generally have no cost per use and therefore, the other elements of the value proposition matter more than the price of postage.

New Management and Strategy

There was a management change at the end of the 3rd quarter of 1998. Many in the mailing community expressed their feelings that the Postal Service was earning too much money and that the profits were excessive. New management promised to solve that problem, and solve it they did. Billion dollar profits were replaced by billion dollar losses.

Instead of emphasizing the value of its products and prioritizing revenue protection, management focused on cost reduction—not just through further automation and streamlining of postal networks, but through cuts in service. This strategy seems to have hit rock bottom with the proposal to eliminate Saturday delivery and close facilities needed to provide universal service.

This counterproductive shift in strategy was, ironically, made possible by the financial success of the Postal Service in the 1990s. New management changed the business strategy to one that focused solely on productivity and discounts, rather than the total value mix outlined above. Management began to view the primary customer as the representative of the large mailer instead of the individual consumer. These representatives focus on obtaining discounts for their clients, the large mailers, and /or converting first class mail to less expensive categories of mail.

The apparent goal of the Postal Service was to grow volume and restrain or eliminate price increases. Neither goal was achieved.

Discounts

The Postal Service said that if prices were cut, then volume would increase. This was generally true, but deceptive. Some of the services had price inelastic demand. As an example, if the Postal Service cut prices by 10% for a large mailer and achieved a 2% increase in volume, revenues would drop by 8%. Clearly, this was a financial problem.

Even if revenue increased slightly, as is the case with elastic demand, the effect would be negative on money to cover fixed costs and profits, and it would speed up the need for a rate increase. To illustrate, consider a $1 billion service with a 25% contribution margin. This means that direct costs would be $750 million and contribution, money to cover fixed costs, would be $250 million.

Now, consider what would happen if the Postal Service cut price by 10% and revenue dropped to $900 million. If volume increases 15%, revenue now becomes $1,035 million ($900 million x 1.15 = $1,035 million). The fact that revenue increases with a price cut does not mean that this price cut is beneficial.

A 15% increase in volume also means that costs go up 15% to $863 million. What appears to be a situation that leaves the Postal Service better off by the 3.5% increase in revenue actually hurts the financial condition dramatically. Contribution falls by 31% despite the revenue increase. Because costs rise to $863 million, the Postal Service has $78 million less cash to cover fixed costs. The table below shows this effect.

THE EFFECT OF PRICE CUTTING: FINANCIAL DISTRESS

	Original Case	10% Price Cut	15% Volume Increase	Difference
Revenue	$1, 000	$900	$1,035	+$35
Attributable Costs	$750	$750	$863	($113)
Contribution	$250	$150	$172	($78)

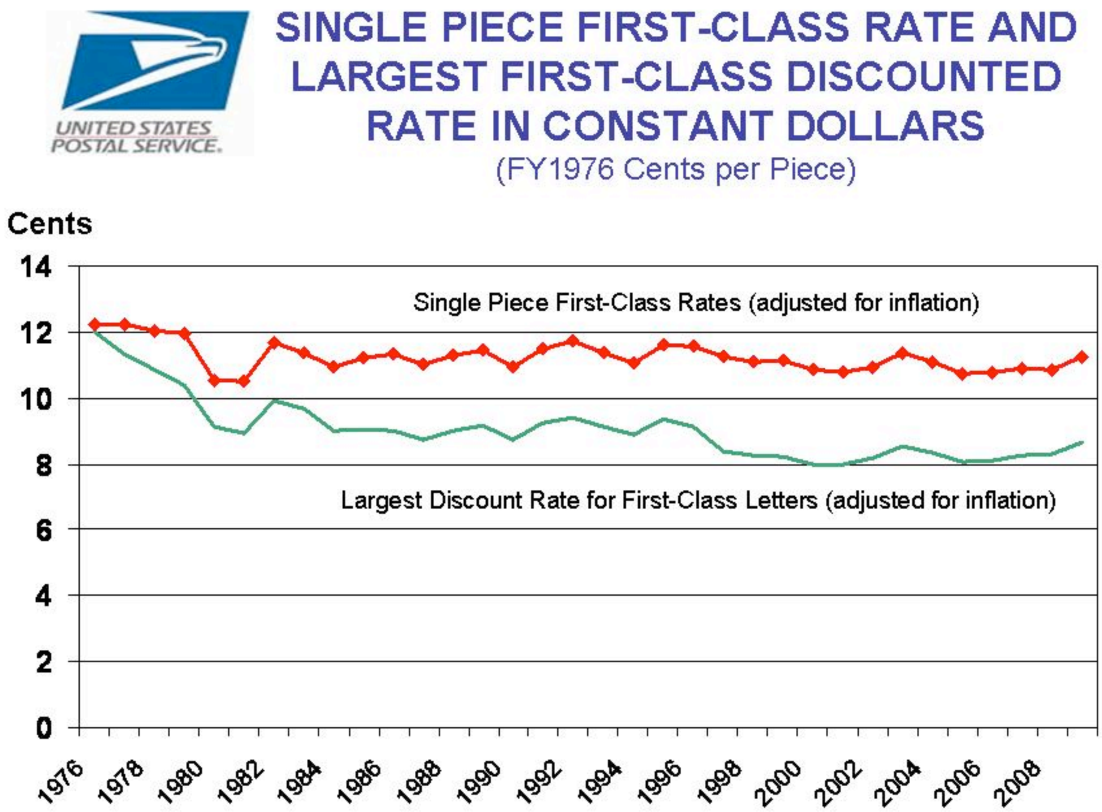
When a mailer can sort mail in the computer, the Postal Service saves costs. We should expect the Postal Service to share the benefit with the mailer through work-share discounts. But, rather than share the benefits equally between the Postal Service and the mailer, work-share discounts grew to give away all of the savings and more too. The initial result was slightly more mail and substantially less contribution to cover fixed costs. Of course, with the recession, mail volume is now down by a very large amount.

Work-share discounts equal to costs saved are still too high. Work-share discounts should be less than costs saved to provide added contribution to the Postal Service. In conclusion, the under-pricing of mail is a significant reason for the Postal Service's current financial distress.

Inflation and Mail Volume

The price of a first class stamp has risen slightly less than inflation during the period from 1976 to the present. As we would expect for a service business, this has not protected mail volume. Other elements in the consumer value mix are more important.

The graph below compares the price of a single first class stamp and the rate for the most discounted work-shared mail adjusted for inflation. As you will see, both single stamp prices and work-share rates have increased less than inflation since 1976. This graph also shows the increase of work-share discounts relative to the price of a single first class stamp over this period.



Mail volume has grown over the years and recent volume declines are unrelated to the prices. Only an end to the recession promises to restore volume.

Saturday Delivery

The Postal Service has projected great cost savings from the elimination of Saturday delivery. It assumes that this will have no effect on revenue and that is naïve. It is one strong signal to customers that the Postal Service is slowly going out of business. If only 10% of customers give up on the Postal Service and convert to electronic bill paying, that will offset any projected savings.

But far more important is the direction of Postal strategy. The elimination of Saturday delivery is in direct opposition to the idea of the individual as the primary customer. Successful businesses find ways to delight various segments of their customer base. At best, many customers will not care about the elimination of Saturday delivery, while many will certainly be distressed.

This is a step that will not be easily reversed.

And the following promise is one of failure. “Eliminate Saturday delivery and ‘only’ lose $115 billion over the next 10 years.” This is hardly a rallying cry for success.

Today

After 12 years, the price of a stamp is 12 cents higher than in 1998 and mail volume is lower. Instead of billion dollar profits, the Postal Service needed an emergency $4 billion bailout from Congress last September and still lost $3.8 billion in 2009. There is no money for capital and anecdotes abound about dissatisfied customers.

In June 1998, the Consumer Price Index stood at 163.0. It increased to 217.6 in March 2010, an increase of 33.5%. The price of a first class stamp is 37.5% higher than it was in June 1998. Despite increasing the price of the stamp to the public, the Postal Service has gone from a strong financial position to one of financial disaster.

There are 2 small positive innovations in an otherwise bleak outlook.

The Forever Stamp is a customer convenience and likely produces savings enough to cover the costs. It costs the Postal Service about 1 cent to create, print, and distribute a new 1-cent stamp. This means that there is no net loss by allowing customers to use the forever stamp. Customers tend to misplace and lose some percentage of their stamps and the Postal service earns a return on their funds paid in advance of need. So, the Postal Service can provide a convenience that Customers like and added value without cost.

The new advertising campaign, "If it fits, it ships," focuses on value, not discounts. The customers like getting "free" boxes and enjoy the convenience of not having to weigh the package to figure out postage.

No Cash for Opportunity

There are numerous opportunities for improvement to delight customers and thereby increase mail volume. Unfortunately, the Postal Service lacks the money to implement these initiatives in its current state. The following is a short list of examples:

- Advertise 7 day-a-week delivery of Express Mail.
- Open a window at mail processing facilities for 24 hour, 7 day a week mailing similar to what used to be the case at National and Dulles airports.
- Use the Internet and password protected communications to allow retired individuals to direct their mail to multiple locations while away from home. This is a variation of the current "Snow Bird" mail service.
- Advertise the current "Snow Bird" mail service. The $15, once a week, Priority Mail Forwarding program, earns the Postal Service $60 in revenue per month for a service that costs less than the current free mail forwarding program. In fact, this service should be expanded to offer the service for 2 or 3 days each week if desired.
- Return to the 5-minute line wait policy. Last Christmas, I turned around from my local Post Office with an hour wait and mailed my presents at the UPS store. The wait there was 10 minutes.
- Open high-volume, high-service locations for the mailing public with very friendly employees. Merrifield, VA has such a location. It has been open 7 days a week and has been open as late as 10 PM.

- Use direct mail advertising to inform customers about such locations. Direct mail advertising works very well. The Postal Service should try it for its own advertising.
- Improve the speed and reliability of mail other than First Class. Certified mail is not reliable nor is it fast.
- Provide locked package lockers to individuals to allow secure package delivery while the customer is away from home during the work day.

It should be noted that this list is far from exhaustive and focuses on the individual as the primary customer.

10-Year Plan

On March 2, 2010, the Postal Service issued a press release that predicted losses of $238 billion over 10 years on its present track and promised to limit these losses to only $115 billion if Saturday delivery is eliminated.

Confucius, Henry Ford, and Will Smith have all said: "If you think you can, you are right. If you think you can't you are right." When it comes to a strategy for financial success, it appears that the Postal Service thinks it can't.

Rather than forecast dramatic losses, it would be far better to devote the energy to a dramatic change in direction to achieve long-term success. The Postal Service can be profitable, customers can be delighted, and the employees can be managed well. All it takes is the right leadership, leadership that thinks it can succeed.

Tomorrow

The Postal Service needs a business strategy that works. It needs to increase profitable revenue to provide capital for replacement equipment, vehicles, and new or improved services that will delight customers. With a different focus, long-term success is possible. Indeed, with the right focus, success is highly likely.

Congress can help. It can keep the requirement already in law that postal work-share discounts may not exceed the costs that the work-sharing activity saves the Postal Service. It can mandate the continuance of Saturday delivery. It can amend the Postal Accountability and Enhancement Act of 2006 to eliminate the pre-funding of health care costs and thus put the Postal Service on par with other large companies. It would be very helpful to also recognize the need for a surplus created by profits along the lines of a mutual company.

Thank you,

Michael J. Riley, DBA

Biography of Michael J. Riley, DBA

Dr. Michael J. Riley is a Professor of Business and Executive Programs at the University of Maryland University College. He teaches finance, economics, and accounting to MBAs and executive MBAs. In addition, he has taught marketing and strategy. He also owns his own consulting company, Riley Associates, LLC.

His business career includes service as CFO of the U.S. Postal Service from 1993 to 1998.

Previously he was CFO of Lee Enterprises, CFO of United Airlines, Treasurer of Michigan Bell Telephone Company, and Assistant Controller of Northeast Utilities.

He serves on the Board of Directors of Church Mutual Insurance Company and is Chairman of its Audit Committee. He was Chairman of the Audit Committee of the Architect of the Capitol from 2003 to 2010.

Dr. Riley earned a Doctor of Business Administration from Harvard University, an MBA from the University of Southern California, and a BS from the U.S. Naval Academy. He has served as an adjunct faculty member at Harvard University, Boston University, University of Connecticut, University of Michigan, and George Mason University.