



OFFICE OF **INSPECTOR GENERAL**

UNITED STATES POSTAL SERVICE

U.S. Postal Service Revenue: Is the Glass Half Empty or Half Full?

RARC Report

Report Number
RARC-WP-15-008

April 13, 2015





OFFICE OF INSPECTOR GENERAL

UNITED STATES POSTAL SERVICE

Executive Summary

***The Postal Service earned
\$1.4 billion in controllable
operating income in FY 2014.***

For the last few years, the predominant headline regarding the U.S. Postal Service has been that it is in a financial crisis, but there is recent evidence that the Postal Service may be turning the financial corner. Nevertheless, the Postal Service still faces numerous challenges and will need to continue to evolve and focus on revenue opportunities.

At first glance, the Postal Service still appears to be losing money. In fiscal year (FY) 2014, it reported a net loss of \$5.5 billion.¹ However, these losses are driven by two requirements that are out of the Postal Service's control: the requirement to prefund its retiree health benefits fund and its workers' compensation expenses. After taking these expenses out of the equation, the Postal Service earned \$1.4 billion in controllable operating income in FY 2014. Further, it has earned a total of \$1.7 billion in cumulative operating income since 2006.² This notable, yet rarely mentioned, financial performance is surprising given the period 2006-2014 encompasses the Great Recession of 2008, the post-recession economic slump, and the continued electronic diversion of First-Class Mail. This return to a positive controllable operating income seems to stem from three areas of strength: an increase in parcel volumes, significant cost reductions, and the exigent price increase.

The data offer some hope that the Postal Service's financial situation may not be as dire as first thought. Instead, the

¹ U.S. Postal Service, *2014 Report on Form 10-K, USPS 10K 2014*, <http://about.usps.com/who-we-are/financials/10k-reports/fy2014.pdf>.

² Ibid.

Highlights

The Postal Service's financial health seems to be improving; in FY 2014 it had a controllable operating income of \$1.4 billion.

The Postal Service's move to a positive controllable operating income appears to be driven by

- (1) an increase in parcel volumes,
- (2) significant cost reductions, and
- (3) the exigent price increase.

While it is showing signs of improving financial health, the Postal Service still faces challenges stabilizing and improving its revenue. It will need to focus its efforts on improving its revenue yield on its traditional business and pursue a revenue diversification strategy.

Postal Service's cup, figuratively speaking, now seems half full, and it remains to be seen if the cup will continue to fill up or will slowly empty.

The Postal Service faces conflicting opportunities and challenges that will affect its revenue.

The challenges facing the Postal Service are not modest in nature, but neither are they insurmountable.

- While continually raising prices is not feasible or desirable, there is some evidence to show that moderate, predictable price increases can help the Postal Service's revenue. In January 2014, the Postal Service implemented prices on its market dominant products that were higher than what its rate cap allows. Many opponents of this exigent price surcharge claimed it would cause large drops in volume and ultimately lead to lower overall revenue. To date, the huge volume declines have not occurred. However, future revenue growth cannot rely on price increases alone. Not only is there a limit to how frequent and how high of price increases mailers will tolerate, the Postal Service is also constrained by having a price cap on the majority of its products. Furthermore, the Postal Service could be required to eliminate the exigent price surcharge that is currently in place after it has earned a certain level of revenue, which will most likely occur in the summer of 2015.
- The Postal Service has benefited, and should continue to benefit, from a large increase in parcel growth. Shipping and Packaging Services revenue grew 8.7 percent in 2013 and 9.1 percent in 2014.³ While the Postal Service has taken innovative steps in the parcel market, such as partnering with Amazon for Sunday delivery and grocery delivery, it faces increasing competition from a crowded field of established players and start-ups.
- The Postal Service has been cutting costs in order to increase net revenue. The Postal Service has reduced workhours by 420 million hours since 2002, yielding over \$17 billion in annual savings.⁴ However, there is a limit to how much the Postal Service can cut without degrading service, and some have claimed that it has already gone too far.
- There is a fundamental change in mail demand that affects the Postal Service's main source of revenue. First-Class Mail, the Postal Service's biggest provider of contribution to institutional cost, continues to decline, especially in the areas of transactional mail. While consumers still seem to value getting hard-copy bills mailed to them, they are increasingly paying their bills electronically instead of by mail.
- While there has been evidence that physical advertising mail is still effective, it has become a less predictable source of revenue. Until recently, advertising revenue tracked fairly closely with the economy, but that link is not as strong as it used to be. While advertising mail appeared to be on a modest rebound, it declined slightly in 2014.
- As volumes decline overall, and delivery points continue to increase, the Postal Service faces the risk of reduced contribution per delivery point for an indefinite period. This will make it increasingly difficult for mail alone to fund the cost of delivery.
- The Postal Service, and the American public, could benefit from the Postal Service offering new products and services, but current law constrains the Postal Service's ability to diversify.

The challenges facing the Postal Service are not modest in nature, but neither are they insurmountable. In order to remain financially solvent, the Postal Service will need to focus on generating additional revenue through increasing the revenue yield of its traditional products where the market forces and conditions will allow it, and diversifying into other areas of business, especially adjacent spaces like logistics and financial services. A 2013 report by Accenture found that the posts with the highest performance are the ones that have put the most focus on diversification.⁵

³ U.S. Postal Service, *2014 Report on Form 10-K, USPS 10K 2014*, <http://about.usps.com/who-we-are/financials/10k-reports/fy2014.pdf>.

⁴ Ibid.

⁵ Accenture, *Achieving High Performance in the Postal Industry*, *Accenture Research and Insights 2014*, 2014, <http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture-Achieving-High-Performance-Postal-Industry-2014.pdf>.

Table of Contents

Cover	
Executive Summary.....	1
Observations	4
Introduction	4
Areas of Strength	4
Parcel Volumes Increased Significantly	4
Cost Cutting Has Improved Net Income	5
Exigent Price Increase Did Not Drive Volume Away	5
Challenges and Opportunities.....	7
As Volumes Decline, Contribution per Delivery Will Be Difficult to Sustain	7
Cost Cutting May Become More Challenging	8
Maintaining Revenue from Traditional Letter Mail Will Be Challenging	8
Revenue Opportunities for Non-Letter Products Hinge on Price and Volume	13
Conclusion	15
Contact Information	16

Observations

The Postal Service's return to a positive controllable operating income seems to stem from three areas of strength: an increase in parcel volumes, significant cost reductions, and the exigent price increase.

Introduction

For the last few years, the predominant headline regarding the U.S. Postal Service has been that it is in a financial crisis, but recent evidence shows that the Postal Service may be turning the financial corner. At first glance, the Postal Service still appears to be losing money. In fiscal year (FY) 2014, it reported a net loss of \$5.5 billion.⁶ However, these losses are driven by two requirements that are out of the Postal Service's control:

- The Postal Service's requirement to put aside money each year to prefund its retiree health benefits fund. While the Postal Service has not made these payments in recent years, the monies are still recorded as an expense. This expense was \$5.7 billion in FY 2014.⁷
- Expenses related to the change in the calculation of the future workers' compensation liability, including discount rate changes and re-evaluation of the related liability. These changes are reflected as expenses to the Postal Service, even though they do not affect the cash flow. These expenses totaled \$1.2 billion in FY 2014.⁸

After taking these expenses out of the equation, the Postal Service earned \$1.4 billion in controllable operating income in FY 2014.⁹ Further, it has earned a total of \$1.7 billion in cumulative operating income since 2006.¹⁰ This notable, yet rarely mentioned, financial performance is surprising given the period 2006-2014 includes the Great Recession of 2008, the post-recession economic slump, and the continued electronic diversion of First-Class Mail. In addition, these expenses only reflect estimations of future liabilities, and these estimations can change as the assumptions behind them vary. For example, the expenses related to future workers' compensation liability are very sensitive to the interest rate. Furthermore, as discussed in the OIG white paper, *Considerations in Structuring Estimated Liabilities*, there are several reasons why these liabilities may be overstated. For example, requiring retiree participation in Medicare parts A, B, and D, as part of a health care plan the Postal Service proposed in FY 2012, would reduce the retiree healthcare liability by \$42.9 billion.¹¹ Furthermore, using Postal Service-specific demographic and economic assumptions in the estimation of the liabilities would reduce the combined retiree health care and pension liabilities by \$8.5 billion.¹² Therefore, it seems likely that the Postal Service liabilities are overstated, which further supports the notion that Postal Service finances may not be as bad as first thought.

Areas of Strength

The Postal Service's return to a positive controllable operating income seems to stem from three areas of strength: an increase in parcel volumes, significant cost reductions, and the exigent price increase. Each of these is discussed in more detail below.

Parcel Volumes Increased Significantly

While transactional and advertising volumes are falling or stagnating, the Postal Service has benefited from the e-commerce-fueled expansion in the package delivery market. As can be seen in [Figure 1](#), revenue from Shipping and Package Services increased by nearly 20 percent over two years.¹³ This corresponded with a 15 percent increase in volumes over the same period.¹⁴ While parcel

⁶ U.S. Postal Service, *2014 Report on Form 10-K, USPS 10K 2014*, <http://about.usps.com/who-we-are/financials/10k-reports/fy2014.pdf>, p. 13.

⁷ *Ibid.*, p. 14.

⁸ *Ibid.* (\$1.2 billion is the sum of 485 million and 697 million).

⁹ *Ibid.*

¹⁰ OIG Analysis of Postal Service historical annual report data, FY 2006–FY 2014.

¹¹ U.S. Postal Service Office of Inspector General, *Considerations in Structuring Estimated Liabilities*, Report Number FT-WP-15-003, January 23, 2015, <https://www.uspsoidg.gov/sites/default/files/document-library-files/2015/ft-wp-15-003.pdf>, p. 7.

¹² *Ibid.*

¹³ U.S. Postal Service, *2014 Report on Form 10-K, USPS 10K 2014*, p. 18. Shipping and Package Services include Priority Mail, Parcel Select, Parcel Return, Standard Parcels, Package Services, First-Class Packages, and Priority Mail Express.

¹⁴ *Ibid.*, p. 18.

These cost reductions have helped the Postal Service offset the effect of declining volumes on postal revenues.

revenue is still small compared to First-Class Mail revenue, the increase in parcel revenue did have a positive impact on Postal Service revenue.

Cost Cutting Has Improved Net Income

■ The Postal Service has made efforts to cut its operating expenses in the past couple of years. Some of the efforts include network consolidation and reduced window hours. In addition, even while delivery points are growing, the Postal Service has managed to eliminate 23,000 delivery routes through delivery route consolidation.¹⁵ According to the Postal Service, the most significant impact on compensation expenses in the last two years has been the use of more non-career employee workhours.¹⁶ In addition, the Postal Service has been able to reduce total workhours overall. Since 2002, total workhours have been reduced by 420 million, yielding over \$17 billion in annual savings.¹⁷ These cost reductions have helped the Postal Service offset the effect of declining volumes on postal revenues.

Exigent Price Increase Did Not Drive Volume Away

On September 26, 2013 the Postal Service requested an “exigent” price increase, a price increase for market dominant products that is above the allowable cap.¹⁸ In response to this request, numerous mailers commented that the exigent price increase would drive away mail volumes.¹⁹ The Postal Regulatory Commission (PRC) approved the rate increase, but only as a temporary surcharge that would be eliminated once the revenue earned from the surcharge reached \$3.2 billion, the amount PRC determined was necessary to make up for the contribution the Postal Service lost due to the Great Recession.²⁰ Since the surcharge was implemented on January 26, 2014, there is not a full fiscal year of data that reflects the volumes and revenue related to the surcharge. However, quarterly data can be used to compare an almost full 12 months of data before and after the exigent

¹⁵ Patrick R. Donahoe, “Postmaster General Addresses National Press Club” (January 06, 2015) http://about.usps.com/news/national-releases/2015/pr15_001.htm.

¹⁶ Ibid., p. 20.

¹⁷ Ibid., p. 21.

¹⁸ The Postal Accountability and Enhancement Act of 2006 gave the Postal Service the ability to request rate increases for market dominant products above the cap “...on an expedited basis due to either extraordinary or exceptional circumstances...” 39 U.S.C. § 3622 (d)(1)(E).

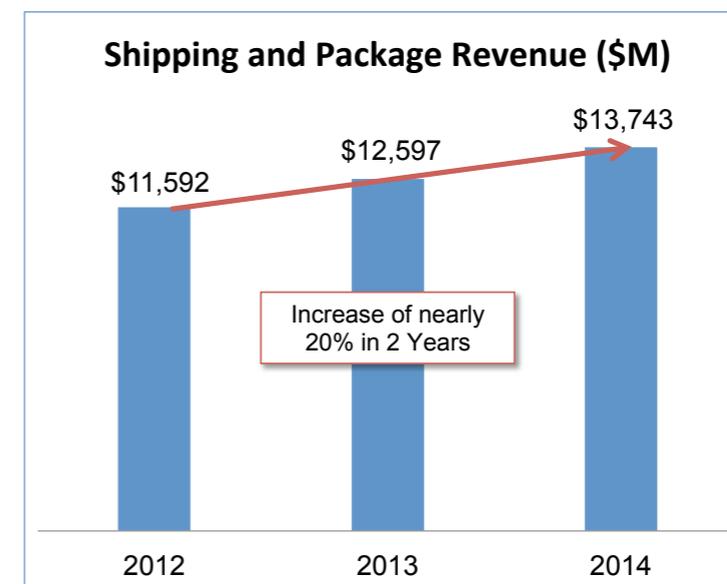
¹⁹ For example, in its comments to the Postal Regulatory Commission, the American Bankers Association said that the exigent price increase could increase electronic diversion and negatively impact mail volume. American Bankers Association, “Comments of American Bankers Association,” Postal Regulatory Commission (PRC) Docket No. R201311, November 26, 2013, <http://www.prc.gov/Docs/88/88406/ABA%20Comments%20on%20PRC%20R2013-11.pdf>.

²⁰ PRC, *Order Granting Exigent Price Increase*, Docket No. R2013-11, December 24, 2013, http://www.prc.gov/Docs/88/88645/Order_1926.pdf, p 184. The PRC estimated that the Postal Service lost \$2.8 billion in contribution due to the Great Recession and that they would need \$3.2 billion in revenue in order to reach that contribution goal.

Figure 1: Parcel Revenue Growth

Parcel Revenue Increased Nearly 20 Percent in Two Years

The e-commerce fueled package growth has had a positive impact on Postal Service revenue.



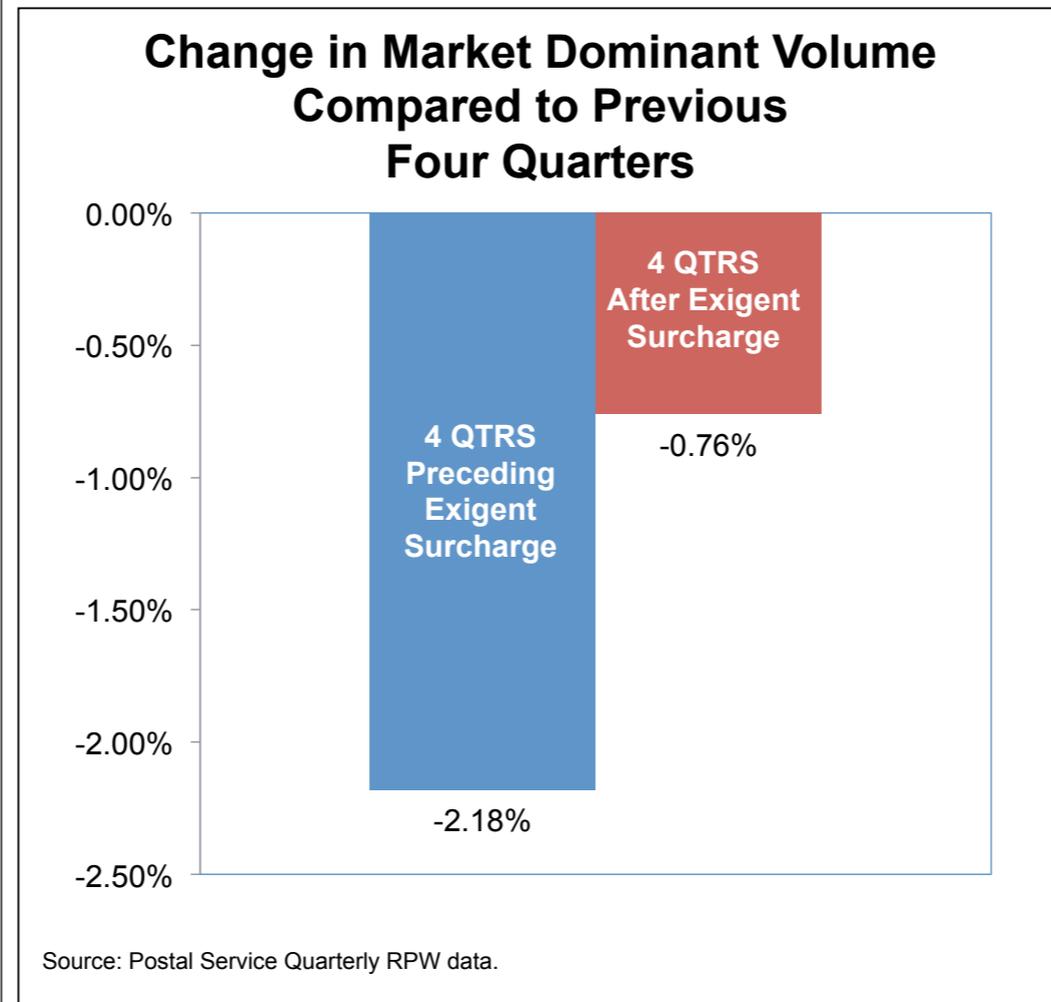
Source: USPS 2014 10K.

surcharge, and this data suggests that the price increase was not detrimental to the Postal Service.²¹ Instead, while there was some decline in market dominant volumes after the surcharge was implemented, the volume decline was actually less than it was prior to the surcharge.

Figure 2 shows the change in volume for two separate four-quarter periods (1) the four quarters preceding the exigent surcharge, and (2) the four quarters following the exigent surcharge.²² While market dominant volumes declined by 0.76 percent in the four quarters following the exigent surcharge, this decline was actually less than the volume decline in the four quarters preceding the surcharge.

Figure 2: Volume Declined Less After Surcharge than Before Surcharge

While there was some decline in market dominant volumes after the surcharge was implemented, the volume decline was actually less than it was prior to the surcharge.



²¹ Using quarterly data does not exactly give us a full year of data with and without the surcharge. Quarter 2 contains data for January to March, and the rate increase was January 26th. However, we believe that quarterly data gives us a decent picture for the purpose of this analysis.

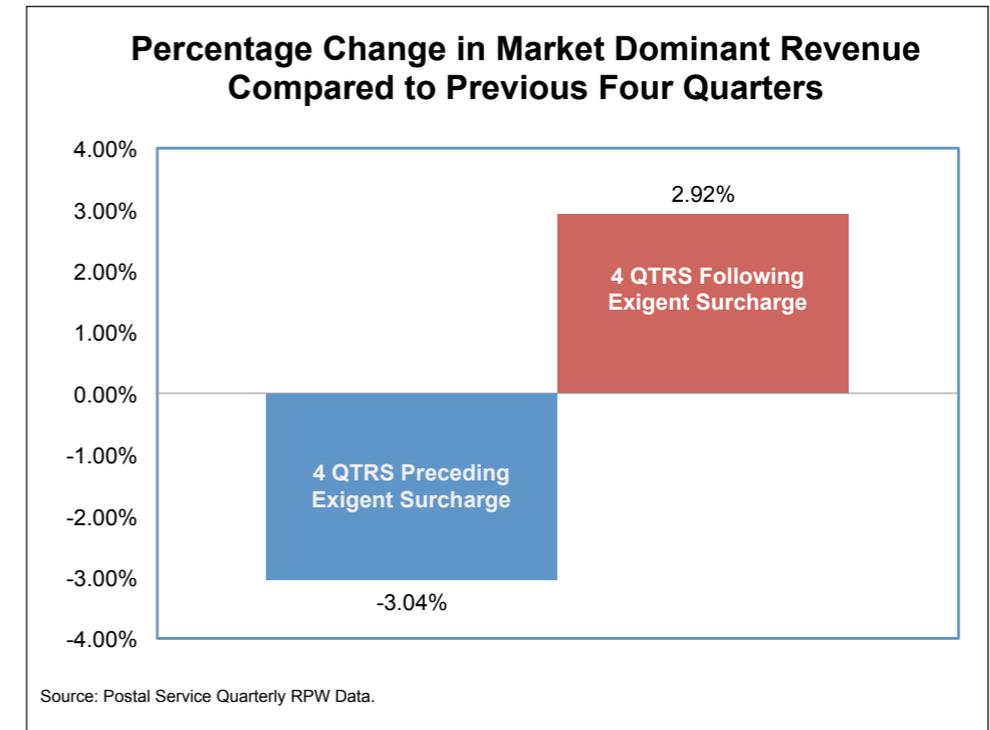
²² The four quarters preceding the exigent surcharge represents the change in volume between the four quarters ending in QTR 1, FY 14 (QTR 2, FY 13 through QTR 1, FY 14) and the same four quarters from the previous year (QTR 2, FY 12 through QTR 1, FY 13). The four quarters following the surcharge represent the change in volume between the four quarters ending in QTR 1, FY 15 (QTR 2, FY 14 through QTR 1, FY 15) and the four quarters from the previous year (QTR 2, FY 13 through QTR 1, FY 14).

Even more important, the data shows that the exigent surcharge has led to an increase of revenue for market dominant products.

Even more important, the data shows that the exigent surcharge has led to an increase of revenue for market dominant products. As shown in Figure 3, market dominant revenue increased by 2.92 percent in the four quarters after the exigent surcharge. This is compared to a 3.04 percent decline in revenue in the four quarters preceding the surcharge.

This increase in revenue may not stem solely from the price increase, as there are many factors that affect mail volume and revenue, and we have not undergone a full analysis of the impact of price on mail demand. For example, the economy has seen significant improvement in 2014 and this most likely has a positive effect on volume. Nevertheless, the data does seem to indicate that moderate price increases can help the Postal Service's finances. However, as mentioned above, the PRC ordered that the exigent surcharge only remain in place until the revenue earned from the surcharge reached \$3.2 billion. As of September 30, 2014, the Postal Service announced that they have collected approximately \$1.4 billion in incremental revenue from the exigent surcharge, and it expected that it would meet the \$3.2 billion sometime during FY 2015.²³ The Postal Service has filed an appeal with the U.S. Court of Appeals for the District of Columbia arguing that the PRC erred in its decision to limit the duration of the surcharge.²⁴ The Court has not yet issued a decision. However, if the appeal is not successful, the Postal Service will likely have to remove the surcharge sometime in FY 2015.

Figure 3: Revenue Increased after Surcharge Was Implemented



The Postal Service still faces an uncertain future — filled with as many challenges as opportunities.

Challenges and Opportunities

While the Postal Service finances are beginning to look more promising, it is still unclear if the Postal Service will be able to continue to improve its financial performance or if it will take a turn for the worse. The Postal Service still faces an uncertain future — filled with as many challenges as opportunities. We discuss some of the most relevant challenges and opportunities below.

As Volumes Decline, Contribution per Delivery Will Be Difficult to Sustain

At the same time that volumes are declining, the number of delivery points continues to grow each year. In FY 2014 alone, the Postal Service added almost 972,000 delivery points, roughly the equivalent of the population of Delaware.²⁵ Between FY 2006 and FY 2014, the number of delivery points grew 5.3 percent.²⁶ The combination of the increasing number of delivery points and the declining volume will make it difficult for the Postal Service to sustain sufficient contribution, or net revenue, to keep up with the

²³ U.S. Postal Service, *2014 Quarter 1, 2015 Report on Form 10-Q*, <http://about.usps.com/who-we-are/financials/financial-conditions-results-reports/fy2015-q1.pdf>, p. 7.

²⁴ Ibid.

²⁵ According to the United States Census Bureau, the population of the state of Delaware in 2014 was 935,614. <http://quickfacts.census.gov/qfd/states/10000.html>. The number of delivery points increased by 972,000 in 2014. U.S. Postal Service, *2014 Report on Form 10-K, USPS 10K 2014*, <http://about.usps.com/who-we-are/financials/10k-reports/fy2014.pdf>, p. 21.

²⁶ In FY 2014, total number of delivery points in the United States was almost 154 million, <http://about.usps.com/who-we-are/postal-facts/decade-of-facts-and-figures.htm>.

The Postal Service has stated that it has deferred necessary investments for several years in order to increase liquidity and it cannot continue to defer these investments.

The Postal Service may be able to maintain revenue using moderate price increases if it does so in a strategic manner.

cost of the growing number of delivery points. As shown in Figure 4, as delivery points rise and volumes decline, the average number of pieces of mail per delivery point is dropping fairly rapidly. Since the cost of delivery is relatively fixed, that is, it does not vary with volume, the Postal Service will need to cover the cost of delivery with fewer pieces of mail.

Cost Cutting May Become More Challenging

As mentioned above, the Postal Service has undergone some significant cost cutting in the last few years. However, there will be limits to how much the Postal Service can cut costs without degrading service to the point it starts losing mail volume. In fact, some have argued that it has already gone too far. There has been negative public reaction to several of its proposed cost cutting measures — including plant consolidation and load levelling.²⁷ In addition, the Postal Service has stated that it has deferred necessary investments for several years in order to increase liquidity and it cannot continue to defer these investments. It states that in order to make necessary investments to address some critical vehicle, facility, and package handling requirements it will need to make cash outlays for capital assets of approximately \$2.0 billion in 2015 and as much as an additional \$8.0 billion in years 2016 through 2020.²⁸

Maintaining Revenue from Traditional Letter Mail Will Be Challenging

As letter volumes decline, especially First-Class Mail letters, it will be difficult for the Postal Service to maintain the revenue from these products. However, the relative insensitivity to moderate price increases recently exhibited is an encouraging sign. The Postal Service may be able to maintain revenue using moderate price increases if it does so in a strategic manner, such as focusing on price increases for products with inelastic demand or focusing on products that are not covering their costs. However, the current price cap on market dominant products places limits on the Postal Service's ability to take advantage of revenue gains from price increases, even when it comes to products not covering their costs.

In addition to the price cap, the Postal Service must rethink its pricing strategies, as the demand for letter mail is changing — for both First-Class Mail and Standard Mail. Each is discussed separately.

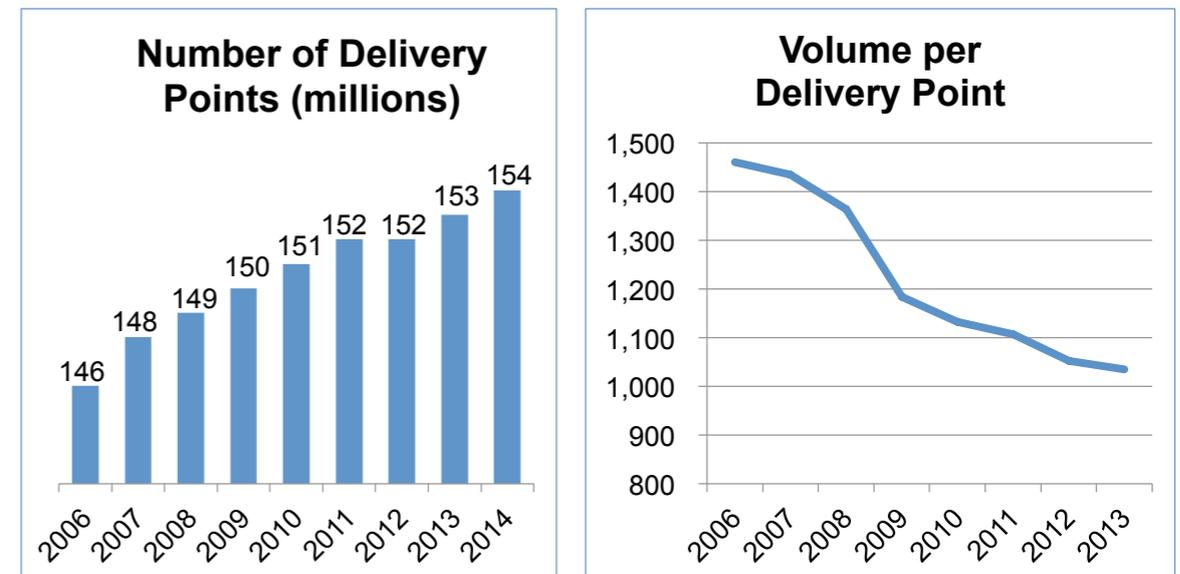
²⁷ For example, in its Advisory Opinion on Load Leveling, the PRC summarized the various parties briefs on this topic. Mailers expressed concern about being able to receive day certain mail. http://www.prc.gov/docs/89/89493/Docket%20No.%20N2014-1_Advisory%20Opinion.pdf, pp. 20-24. In addition, several Senators pushed to stop plant consolidation. <http://www.savethepostoffice.com/postal-service-releases-schedule-plant-consolidations-set-2015>.

²⁸ U.S. Postal Service, *Quarter I, 2015 Report on Form 10-Q*, <http://about.usps.com/who-we-are/financials/financial-conditions-results-reports/fy2015-q1.pdf>, p. 8.

Figure 4: Contribution per Delivery Will Be Difficult to Sustain

The Cost of the Ever Expanding Number of Delivery Points Must Be Funded by Fewer Pieces of Mail Each Year

As overall volume is declining, the number of delivery points continues to grow each year. This results in significantly less mail volume per delivery point. It will become more and more difficult for the revenue from the remaining mail to cover the cost of the delivery points.



Source: Postal Service Data.

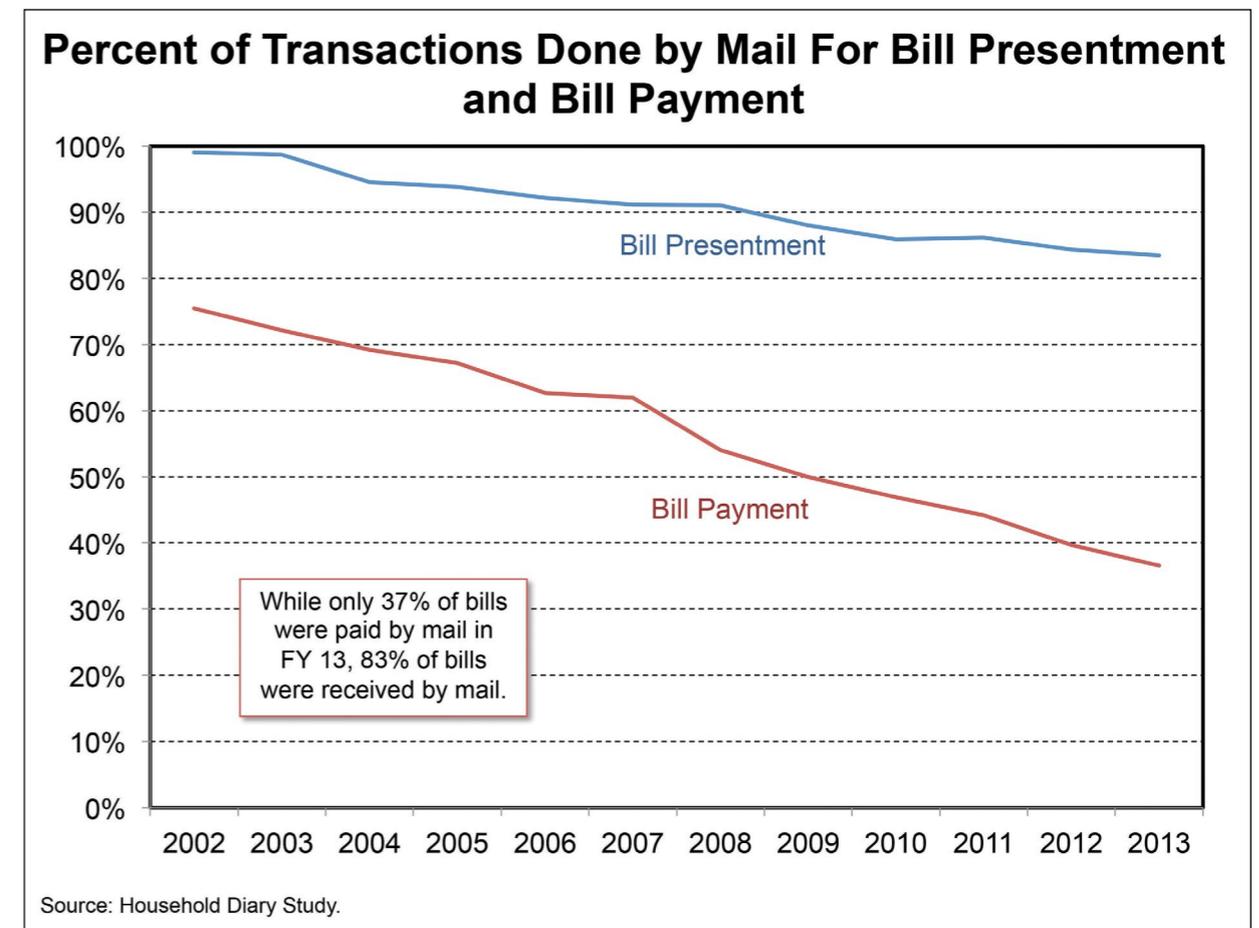
Fundamental Change in Demand for First-Class Mail

Traditionally, First-Class Mail has been a large source of revenue and the largest contributor to Postal Service finances. However, there has been a fundamental shift in the demand for First-Class Mail that largely stems from the introduction of electronic alternatives. Electronic diversion has led to a steady decline in First-Class Mail, especially in the area of personal correspondence. Since FY 2006, personal correspondence has declined by 33 percent.²⁹

In addition, financial transactions have begun to migrate to electronic alternatives, although the trend is markedly different between bill payment and bill presentment. In recent years, automatic deductions and electronic bill payments have accounted for a growing share of household bill payments over time. In FY 2013, 59 percent of bills were paid electronically, an increase from 19 percent in FY 2003.³⁰ This trend is not expected to change as digital natives make up an increasing percentage of the population.

In contrast, the move from hard copy to digital for bill presentment has been much slower, as can be seen in Figure 5. According to the Household Diary Study, in FY 2013, 83 percent of bills were still received through the mail.³¹ A recent survey done by the OIG found that even among the utilities' newest customers — those expected to be more digitally savvy — the vast majority opted to have their bills mailed to them. The report found that consumers value the physical mailpiece as a record keeping tool and a reminder to pay their bills. In addition, unlike bill payment, where consumers save the price of postage if they pay electronically, consumers incur no cost savings if they move to electronic bill presentment.³² Furthermore, when they receive bills online, households must incur the cost of printing the bill if they want to maintain a paper archive. Therefore, there is good reason to believe that the migration of bill presentment to electronic alternatives will continue to be slower than the migration of bill payment.

Figure 5: Bill Presentment and Payment



There is good reason to believe that the migration of bill presentment to electronic alternatives will continue to be slower than the migration of bill payment.

29 U.S. Postal Service, *The Household Diary Study: Mail Use & Attitudes in FY 2007*, <http://about.usps.com/studying-americans-mail-use/household-diary/usps-hds-fy07.pdf>, p. 22 and *FY 2013*, http://www.prc.gov/docs/90/90246/USPS_HDS_FY13.pdf, p. 24.

30 U.S. Postal Service, *The Household Diary Study: Mail Use & Attitudes in FY 2013*, http://www.prc.gov/docs/90/90246/USPS_HDS_FY13.pdf, p. 2.

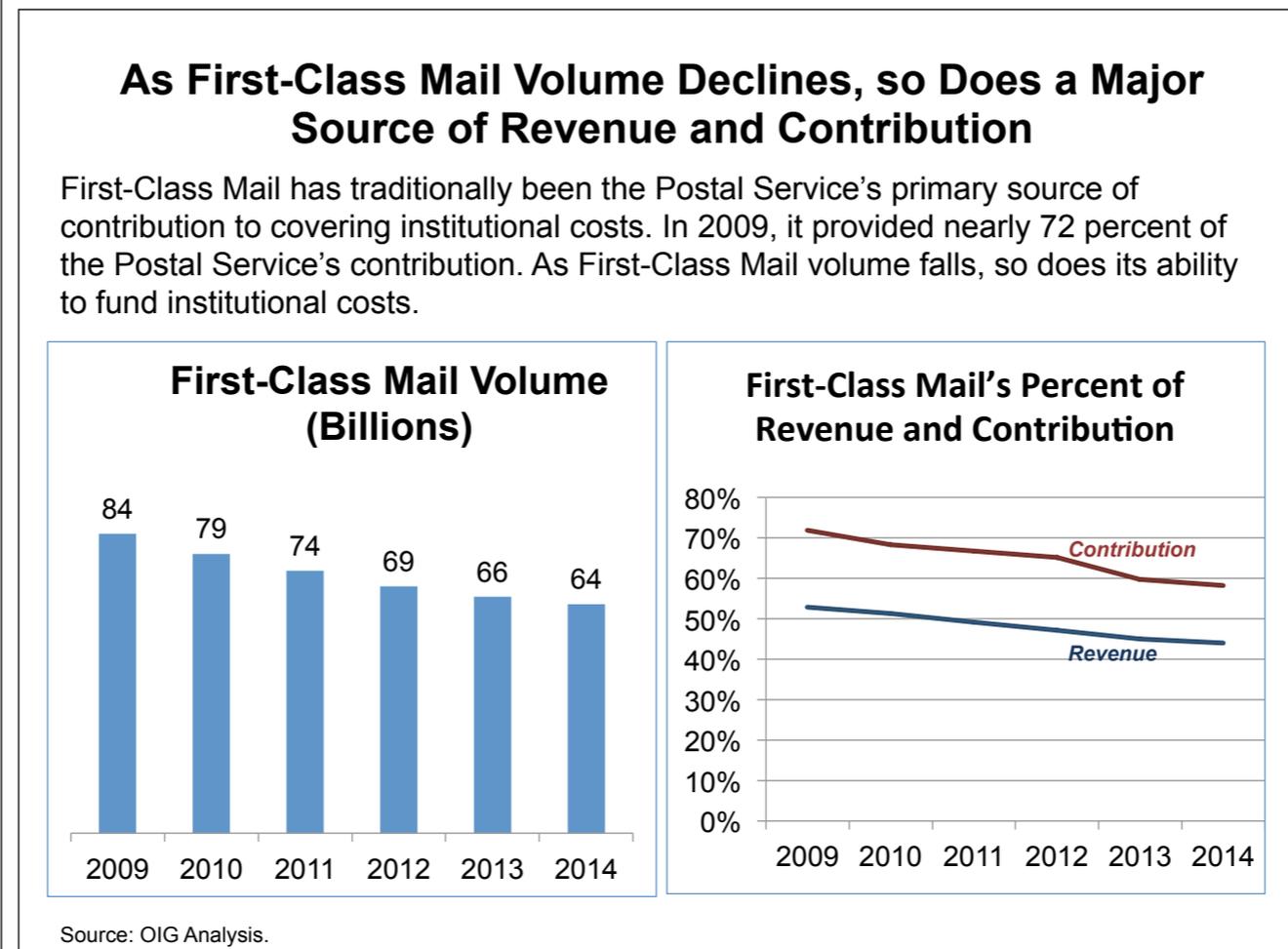
31 *Ibid.*, p. 37.

32 U.S. Postal Service, *Will the Check Be in the Mail? An Examination of Paper and Electronic Transactional Mail*, Report Number RARC-WP-15-006, February 9, 2015, <https://www.uspsoidg.gov/sites/default/files/document-library-files/2015/rarc-wp-15-006.pdf>, p. 1.

The steady decline in First-Class Mail presents a significant financial challenge to the Postal Service, as First-Class Mail has traditionally provided the majority of the revenue and contribution to the Postal Service. While First-Class Mail continues to be the highest contribution product, as volume declines, its contribution to postal finances has been steadily declining. This is shown in Figure 6. Given there are no signs that the Postal Service will be able to reverse this downward volume trend, the Postal Service may need to rely on thoughtful pricing strategies to maximize the revenue from First-Class Mail products. Price increases are most effective in increasing revenue on products that are not sensitive to price changes, that is, have low own-price elasticity. Moreover, a recent OIG study has confirmed that First-Class Mail is price inelastic.³³ The results from that study and evidence from the exigent price surcharge discussed above demonstrate that moderate predictable price increases have the potential to sustain revenue. Currently, the Postal Service is limited by the price cap on market dominant products that restricts it from raising prices above CPI. However, it may be able to focus price increases within First-Class Mail in a manner that maximizes revenue.

The steady decline in First-Class Mail presents a significant financial challenge to the Postal Service, as First-Class Mail has traditionally provided the majority of the revenue and contribution to the Postal Service.

Figure 6: First-Class Mail Decline

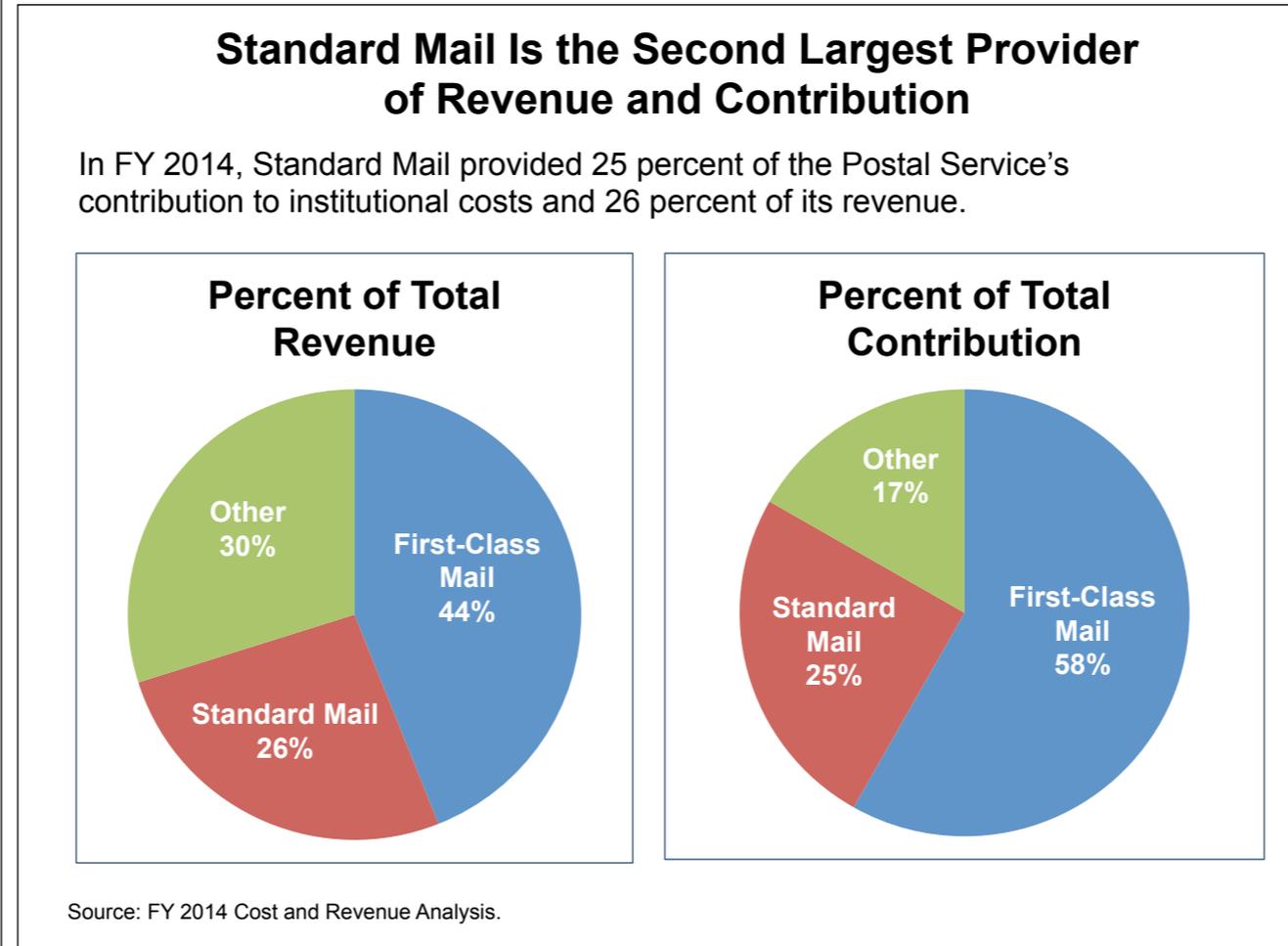


³³ U.S. Postal Service Office of Inspector General, *Analysis of Postal Price Elasticities*, Report Number RARC-WP-13-008, May 1, 2013, <https://www.uspsoidg.gov/sites/default/files/document-library-files/2013/rarc-wp-13-008.pdf>.

Standard Mail Is Less Predictable

While not as large as First-Class Mail, Standard Mail is also a fairly significant provider of revenue and contribution. As shown in Figure 7, in FY 2014, Standard Mail provided 25 percent of the Postal Service's total contribution and 26 percent of its revenue.³⁴ However, unlike First-Class Mail, Standard Mail's revenue and contribution are less stable.

Figure 7: Standard Mail Revenue and Contribution



In recent years, Standard Mail volumes do not appear to be tracking the movement of GPDI as closely as they once did.

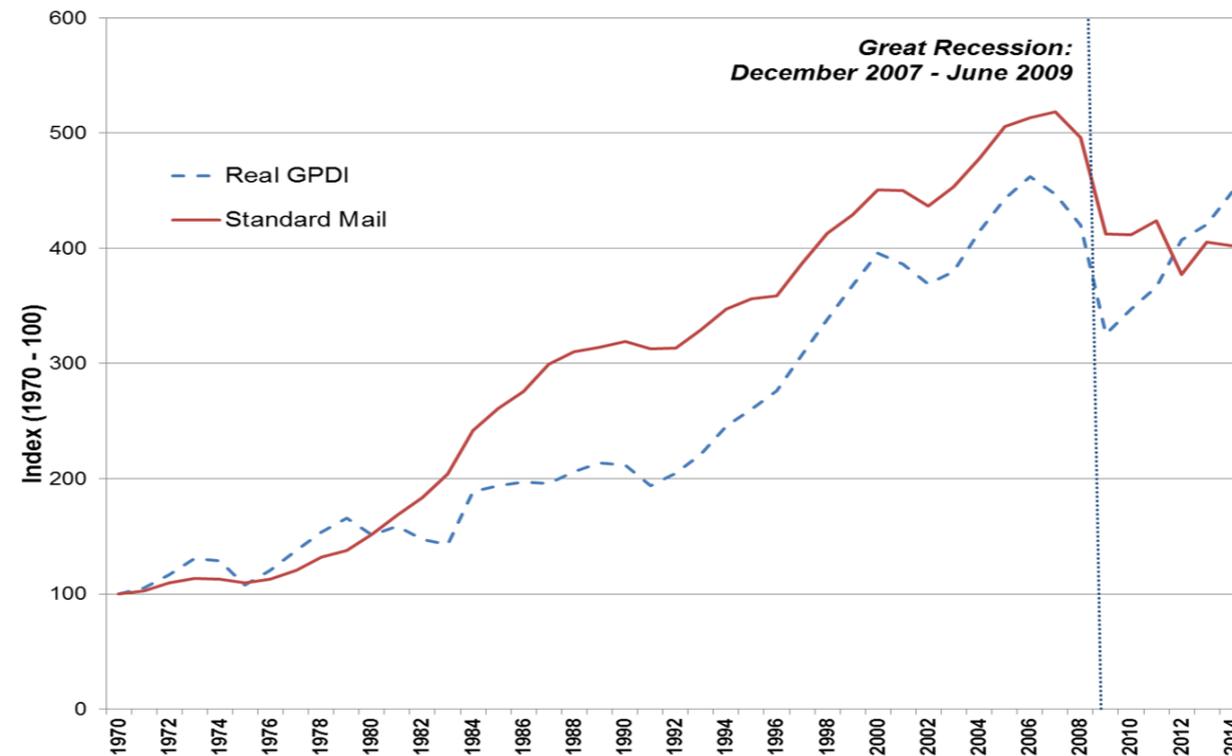
Historically, Standard Mail has tracked the economy fairly closely. While this had the disadvantage of hurting the Postal Service in economic downturns, the revenue fluctuations were at least fairly predictable. For years, Standard Mail volume tracked closely with Gross Private Domestic Investment (GPDI), which tracks capital spending by the private sector. However, in recent years, Standard Mail volumes do not appear to be tracking the movement of GPDI as closely as they once did. In fact, while GPDI continued to increase in FY 2014, Standard Mail decreased by 1.0 percent. This is a reversal from the 1.5 percent growth seen in the previous year. This does not necessarily mean that the link between Standard Mail and GPDI is broken, but it does appear that it is not as strong as it used to be.

³⁴ U.S. Postal Service, *Public Cost Revenue and Analysis, Fiscal Year 2014*, <http://www.prc.gov/docs/91/91009/USPS-FY14-1.Preface.pdf>.

Figure 8: Standard Mail

Standard Mail Is No Longer Tracking Close to GPD

Historically Standard Mail has correlated with changes in economic activity. This relationship has weakened since 2009, making Standard Mail revenues less predictable.



Even as digital advertising grows, there also appears to be a continuing demand for hard copy advertising.

There are reasons to believe that the Postal Service may be able to sustain its Standard Mail revenue. Direct mail advertising allows businesses to target specific customer segments, and there is some evidence that hard copy advertising is still an effective type of marketing. According to the 2013 Household Diary, 76 percent of American households either read or scan advertising mail sent to households.³⁵ In addition, hard copy print is visually and tactilely appealing. It is portable and can be carried without the use of technology.³⁶ Furthermore, hard copy print appears to encourage the reader to pay attention and more easily retain what they have read.³⁷ A recent study has even shown that digital natives prefer reading in print.³⁸ So even as digital advertising grows, there also appears to be a continuing demand for hard copy advertising. Therefore, there is the potential for the Postal Service to be able to grow, or at least maintain, its revenue in this area.

³⁵ U.S. Postal Service, *The Household Diary Study: Mail Use & Attitudes in FY 2013*, http://www.prc.gov/docs/90/90246/USPS_HDS_FY13.pdf, p. 45.

³⁶ Aislinn Barry, "Why Print Media is Still Relevant in the Digital Age," *McKinsey Development Blog*, June 4, 2014, <http://www.mckinseydevelopment.com/blog/bid/349665/Why-Print-Media-Is-Still-Relevant-In-The-Digital-Age>.

³⁷ Naomi Baron, "The Case Against E-readers: Why Reading Paper Books is Better For Your Mind," *Washington Post*, January 12, 2015, <http://www.washingtonpost.com/posteverything/wp/2015/01/12/the-case-against-kindle-why-reading-paper-books-is-better-for-your-mind-and-body/>.

³⁸ Michael S Rosenwald, "Why Digital Natives Prefer Reading in Print. Yes You Read that Right," *Washington Post*, February 22, 2015, http://www.washingtonpost.com/local/why-digital-natives-prefer-reading-in-print-yes-you-read-that-right/2015/02/22/8596ca86-b871-11e4-9423-f3d0a1ec335c_story.html.

Revenue Opportunities for Non-Letter Products Hinge on Price and Volume

Parcels

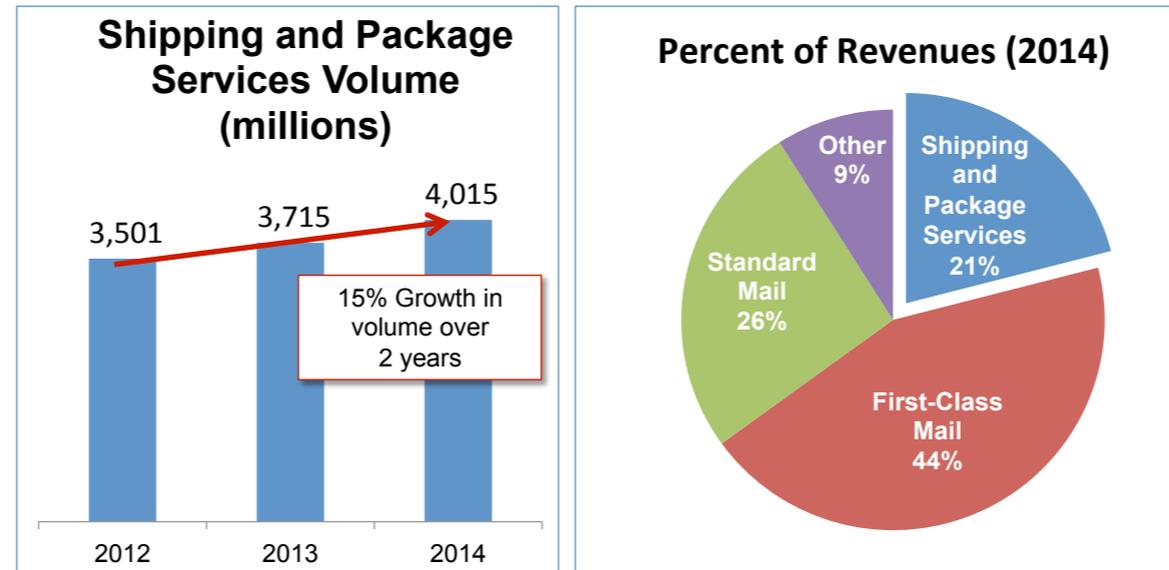
While parcels currently represent a small portion of postal revenue and contribution, it is the one area where there is potential for substantial growth. The Postal Service has benefited and should continue to benefit from a large increase in parcel growth. As shown in Figure 9, Shipping and Packaging Services volume grew 15 percent from 2012 to 2014.³⁹ And while parcel revenue is small in comparison to First-Class Mail revenue, Shipping and Package Services are starting to catch up to the revenue produced by Standard Mail. Currently, Shipping and Package Services make up 21 percent of total postal revenue, while Standard Mail provides 26 percent of total revenue. And there is reason to believe that parcel revenue could continue to grow. In 2014, global business-to-consumer e-commerce sales topped \$1.5 trillion.⁴⁰ If the Postal Service were able to maintain, and possibly even grow, its share of this growing market segment, parcel revenue would play a significant role in keeping the Postal Service financially healthy.

Figure 9: Shipping and Package Services

If the Postal Service were able to maintain, and possibly even grow, its share of this growing market segment, parcel revenue would play a significant role in keeping the Postal Service financially healthy.

Shipping and Package Services Is an Area of Rapid Growth

Due to the surge in online shopping, Shipping and Package Services volume and revenues have grown substantially over the past few years. While it still only comprises 21 percent of total Postal Service revenues, it is one area where there is potential for significant growth.



Source: Postal Service 10K, FY 2014 CRA.

The Postal Service is pursuing revenue opportunities in the parcel market. For example, the Postal Service has entered into a strategic partnership with Amazon to deliver parcels on Sundays.⁴¹ In addition, during the last holiday season, the Postal Service announced that in order to ensure timely holiday deliveries, it would be delivering parcels from all mailers on Sundays.⁴² Furthermore, the Postal Service is currently running a market test with Amazon Fresh, in which it delivers groceries in the early morning. In its filing with the PRC, the Postal Service said that it believes that this type of market test could lead to additional parcel-type deliveries that do not move within the postal system.⁴³ While the Postal Service has demonstrated its ability to be innovative with these new parcel products, it still remains unforeseen whether the revenue from these products will cover the costs of providing them.

³⁹ U.S. Postal Service, *2014 Report on Form 10-K, USPS 10K 2014*, <http://about.usps.com/who-we-are/financials/10k-reports/fy2014.pdf>, p. 18.

⁴⁰ "Global B2C Ecommerce Sales to Hit \$1.5 Trillion This Year Driven by Growth in Emerging Markets," *eMarketer*, February 3, 2014, <http://www.emarketer.com/Article/Global-B2C-Ecommerce-Sales-Hit-15-Trillion-This-Year-Driven-by-Growth-Emerging-Markets/1010575>.

⁴¹ Alistair Barr and Donna Leinwand Leger, "Amazon Starts Sunday delivery with US Postal Service," *USA TODAY*, November 11, 2013, <http://www.usatoday.com/story/tech/2013/11/11/amazon-sunday-delivery-usps/3479055/>.

⁴² U.S. Postal Service Press Release, "Postal Service to delivery packages seven days a week during holidays," November 6, 2014, http://about.usps.com/news/national-releases/2014/pr14_057.htm.

⁴³ U.S. Postal Service Filing at the Postal Regulatory Commission, "Notice of the United States Postal Service of Market Test Of Experimental Product – Customized Delivery," Docket No. MT2014-1, September 23, 2014, <http://www.prc.gov/docs/90/90393/Notice%20Customized%20Delivery%20MT.Public.pdf>, p. 5.

As the decline in letter mail continues, diversification is an essential best practice for high performing posts.

Of course, the downside to the sudden increase in demand for parcel services is an increase in competition in this area. For example, at the same time the Postal Service is partnering with Amazon, Amazon has announced it is testing alternative delivery options, such as running its own delivery service, using drones, and even using trucks with 3-D printers.⁴⁴

Another interesting aspect of the parcel market is the fact that the Postal Service is both in competition and partnerships with fellow parcel delivery companies. This is often referred to as “coopetition.” Both UPS and FedEx use the Package Services destination entry products such as Parcel Select to deliver parcels to residences, presumably when doing so is less costly than delivering themselves.⁴⁵ While this coopetition has benefitted the Postal Service in recent years, there are some signs that the relationship may be tenuous. In the recent docket at the PRC on the Postal Service’s Annual Compliance Report, UPS filed comments that alleged that the Postal Service was attributing far too few costs to its competitive products, products that UPS itself uses.⁴⁶ These comments demonstrate that the Postal Service must be careful with its parcel strategy. While it seeks out new revenue opportunities for parcel services, it also needs to keep an eye on maintaining its current customer base.

In addition to the potential revenue increase due to a growth in parcel volume, the Postal Service may be able to increase its revenue from its parcel products by focusing on how it prices its parcels. Since parcels tend to be very competitive, the Postal Service needs to be cautious not to price itself out of the market. However, on the other hand, the Postal Service should also make sure that it is setting prices in a manner that ensures an appropriate level of contribution to institutional costs.

Diversification

As the decline in letter mail continues, diversification is an essential best practice for high performing posts. In its 2014 study, Accenture found that non-mail revenue, which includes parcels, now exceeds mail revenue for high performing posts — 52 percent versus 48 percent respectively. Their research identified diversification early on as not only a hallmark of high performers, but also as the key to survival in the industry.⁴⁷ The report goes on to say that “while mail is still an important part of the business and will be for some time, most postal organizations are aggressively transforming their businesses into hybrid organizations that provide a range of business offerings — including parcels, logistics, banking, insurance, e-commerce, and digital activities.”⁴⁸

Current law constrains the Postal Service’s ability to diversify, as it is not allowed to provide nonpostal services, except for those “grandfathered in” by the PRC.⁴⁹ However, the Postal Service has been able to participate in some limited diversification. As mentioned earlier, the PRC has recently allowed entry into a market test of grocery deliveries, which are delivered outside of the normal mailstream. In addition, the Postal Service is allowed to provide certain government services for federal agencies, such as providing passports.⁵⁰ Furthermore, the Postal Service has the ability to offer new products. For example, it offers prepaid gift cards, and it may be able to offer additional financial services and other postal products that are similar to the core products it currently offers. The financial health of the Postal Service may depend on its ability to take full advantage of the limited flexibility it has to diversify under the current law.

44 Wohlsen, Marcus, “Jeff Bezos Says Amazon is Seriously Serious About Drone Deliveries,” *Wired*, April 11, 2014, <http://www.wired.com/2014/04/amazon-delivery-drones/> and Krassentein, Brian, “Amazon Files Patent for Mobile 3D Printing Delivery Trucks,” *3DPrint.com*, February 25, 2015, <http://3dprint.com/46934/amazon-3d-printing-patent/>.

45 Laura Stevens, “For FedEx and UPS, A Cheaper Route: The Post Office,” *Wall Street Journal*, August 4, 2014, <http://www.wsj.com/articles/u-s-mail-does-the-trick-for-fedex-ups-1407182247>.

46 “Comments of United Parcel Service on Postal Service’s FY2014 Annual Compliance Report”, Docket No. ACR2014, February 2, 2015, <http://www.prc.gov/docs/91/91320/UPS.14.In.pdf>.

47 Accenture, *Achieving High Performance in the Postal Industry*, Accenture Research and Insights 2014, 2014, <http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture-Achieving-High-Performance-Postal-Industry-2014.pdf>, p. 7.

48 Ibid.

49 39 U.S.C. § 404. The law defines postal services to be “the delivery of letters, printed matter, or mailable packages, including acceptance, collection, sorting, transportation, or other functions ancillary thereto.” 39 U.S.C. § 102.

50 39 U.S.C. § 411.

Whether or not this upswing in net income will continue will depend on the Postal Service's ability to take advantage of its opportunities and manage its numerous challenges.

Conclusion

The Postal Service's financial health appears to be turning the corner, as the Postal Service reported a positive controllable net income of \$1.4 billion for FY 2014. However, whether or not this upswing in net income will continue will depend on the Postal Service's ability to take advantage of its opportunities and manage its numerous challenges. As letter volumes continue to decline and the number of delivery points continues to grow, the Postal Service will face an increasing challenge to maintaining its financial health, and it cannot fix this problem through cost cutting alone. This challenge is exacerbated by the continuing decline in high-contribution First-Class Mail and less predictable volumes for Standard Mail. While the Postal Service may be able to maintain revenue in these areas through thoughtful pricing strategies, the real revenue potential lies in areas outside of traditional letter mail. There has been rapid growth in the parcel market, and whether the Postal Service can continue to benefit from that growth will depend on its ability to innovate and develop a pricing strategy that allows it to attract and maintain customers while ensuring its parcel products are making a reasonable contribution to institutional costs. In addition, the Postal Service and the American public could benefit from the Postal Service offering additional products and services; however, current law limits the Postal Service's ability to diversify into non-postal services and products.



OFFICE OF
**INSPECTOR
GENERAL**
UNITED STATES POSTAL SERVICE

U.S. Postal Service Office of Inspector General
1735 N. Lynn Street
Arlington, VA 22209

Telephone: 703-248-2100
www.uspsoig.gov

For media inquiries, contact Agapi Doulaveris
Telephone: 703-248-2286
adoulaveris@uspsoig.gov