POSTAL TRENDWATCH

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

Postal TrendWatch
Q1, FY08

Q1: Slowing Economy Hits the Postal Service

Executive Summary

Postal Service revenues and volume continued in line with recent trends in Q1 2008 -- revenue climbed and volume decreased for most categories of mail. The decline in volume is particularly noteworthy because USPS management has deemed volume growth, especially in discounted classes like standard mail, central to the agency's financial future. Some executives have begun to question this strategy because standard mail contributes a smaller portion of revenues to institutional costs.

Management attributed some of the blame for the decline in volume to the slowing American economy. Top officials have expressed concern about the effects of a potentially long economic downturn on the agency.

Overview

The Postal Service completed Q1 2008 with higher volume and revenue numbers than the three quarters immediately preceding, thanks largely to the increased mailing activity associated with the holiday season. Such results are generally standard for any given first quarter. The increasing reliance on standard mail raises serious cost coverage questions -- particularly when standard mail volume declines, as it did this quarter.

Holidays Boost Some Indicators, but Worrying Signs Persist

Volume in all sectors except Periodicals declined in Q1 2008 relative to Q1 2007. This includes a downturn of nearly one billion pieces of First Class Mail and nearly 750 million pieces of Standard Mail. Total revenue for Q1 2008 was, however, 3% higher than Q1 2007. First Class revenue was 1.7% higher. In absolute terms, First Class revenue for a first quarter finally surpassed its Q1 2005 level; the rate increase clearly played a role in this development.

First Class Mail was responsible for less than one half of total revenue, continuing a trend that began last quarter. During the last quarter, robust growth in Standard Mail revenues (5.3% over Q4 2006) countered the declining share of revenue contributed by First Class Mail.

But Standard Mail revenues only increased 3.6% this quarter over the same period last year. Because Standard Mail is so dependent on the overall health of the economy, revenue forecasts for the category will depend largely on how deep the looming U.S. recession is.

> *"Two key sectors of the economy -- finance and housing -- suffered a downturn in the first quarter, and they're both heavy users of mail."*
> ---
> *Postmaster General John Potter*

On the bright side, Priority Mail, Package Services, and Periodicals showed healthy revenue growth over Q1 2007, posting increases of 7.4%, 5.3%, and 10.5% respectively. Periodicals faced a significant rate hike in 2007, so it's no surprise that revenue from this class is up.

These hefty revenue growth rates didn't have much impact on the USPS bottom line, as the classes aren't very popular with consumers. Combined, they contributed only 14% of total revenue for the quarter.

Revenue was $663 million higher this quarter than in Q1 2007. But USPS CFO H. Glen Walker did not seem overly optimistic that revenues would continue to grow in line with management's expectations. He pointed to "disturbing trends" in the U.S. economy and lamented that "businesses aren't mailing as much."

Postmaster General John Potter agreed, saying, "Two key sectors of the economy -- finance and housing -- suffered a downturn in the first quarter, and they're both heavy users of mail."

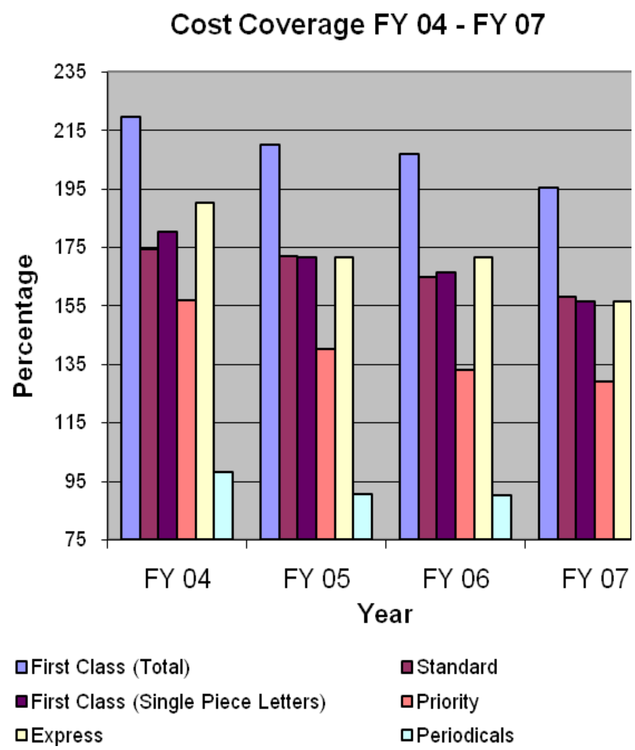
USPS has experienced four consecutive quarters of negative volume growth. With another rate increase on the horizon in Q3 2008 (May 12), it's likely that volume will continue to fall off.

The Best Laid Plans for Growth Fall Short

USPS has been banking on a controversial strategy for revenue growth: increasing volume through bulk discounts and worksharing agreements, particularly in the Standard Mail class. With relatively consistent negative growth in mail volume, however, it's fair to say that the plan has not panned out as promised.

In 2007 Congressional testimony, then-USPS Board of Governors Vice Chairman (and current Chairman) Alan Kessler pointed out that growing the volume without adequate cost coverage could be problematic: "Standard Mail, which contributes significantly less than First-Class Mail to the Postal Service's institutional costs, now comprises the majority of our volume."

The chart below reinforces Kessler's point. USPS has historically relied on First Class Mail to cover the costs of delivering it -- and also contribute an equal amount to the USPS bottom line, for a cost coverage figure of nearly 200%. Standard Mail, by contrast, has historically had cost coverage figures of between 155% and 175%.



The graph above also shows that cost coverage figures are declining across all classes. Standard Mail and Single Piece First Class (letters) have cost coverage figures that have been roughly equivalent over time. Single Piece First Class consumers may be dismayed at the low cost coverage figures for categories like Periodicals and Priority Mail, which do not deliver as much on a percentage basis to Postal Service overhead. In effect, this represents a subsidy of these categories by consumers sending individual letters.

At the same hearing in 2007, Kessler stated that "the business model for the Postal Service -- where steady growth in First-Class Mail finances the expansion of our delivery network to allow for affordable, universal service -- is no longer working."

First Class Mail volume has certainly been declining for some time. This quarter saw a decline of 3.9% from Q1 2007. No quarter has posted an increase in First Class Mail volume over the same quarter of the previous year since Q3 2006, which featured a small gain of 1.2% versus Q3 2005.

Standard Mail volume and revenue growth have been more robust than First Class volume and revenue growth. But it remains to be seen if rate increases and growth in sectors other than First Class will be enough to cover the agency's significant institutional costs.

Former chief economist for the Postal Service Charles Guy is not optimistic about the situation. "The Postal Service has grown accustomed to raising prices for consumers to cover its rising costs," says Guy. "But now the 1-2 punch of the $50 billion pension contribution requirement and the new, hard rate cap [from the recent Postal Accountability and Enhancement Act] makes that strategy impossible."

Revenue growth has been somewhat steady. But when will the dips in volume that accompany rate increases impact the Postal Service's bottom line? That is the billion-dollar question as management struggles to find its way forward after largely successful campaigns to improve productivity and pare the workforce.

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.