The United States Postal Service

Delivering Change to Revitalize an American Icon

The United States Postal Service (the "Postal Service") has played a vital role in our nation's commercial and social fabric for over 250 years. Yet today, it faces an acute financial crisis. Indeed, by its own estimates[(a)], the Postal Service projects that it will run out of cash by sometime this summer or early fall.

In response, the Postal Service has released a "Plan to Profitability" designed to eliminate its large projected operating losses. While this Plan does contain certain credible ideas, its underlying strategic vision is fundamentally flawed. The core idea behind the Postal Service's plan can be summarized as "shrink to survive" – with significant reductions in service and delivery coverage and the elimination of hundreds of thousands of jobs. This strategy undermines the Postal Service's key strategic asset – its unparalleled last-mile delivery network that touches 150 million homes and businesses six days each week. In Lazard's experience, based on our long history of advising on many of the country's most significant restructurings (and many others around the world), we believe that the current Postal Service plan will not create a sustainable enterprise. A business plan based on degrading your greatest strength is not likely to be a path to success.

While the Postal Service clearly faces enormous challenges, we do believe that its revitalization is achievable. To do so will require a comprehensive plan premised on shared sacrifice by all stakeholders, a strategic vision that leverages the strength of its network and supportive legislative action. The Postal Service that results from these changes will have fewer employees, but will enhance (rather than degrade) the quality and value of the essential services it provides to millions of households and American businesses. Similar to any successful private sector restructuring, the Postal Service requires a business plan based on a fundamental rethinking of the institution, top-to-bottom changes in its operations and culture and a first-rate management team and corporate governance structure to ensure that the plan is effectively executed.

The "Plan to Profitability"

In February 2012, the Postal Service publicly released its "Plan to Profitability – 5 Year Business Plan" (the "Business Plan"). The Business Plan is based on certain assumptions regarding general macroeconomic conditions, overall demand for postal products and a set of specific initiatives that the Postal Service intends to pursue. Many of these assumptions, including the overall demand for postal products and the continuing secular decline of first class mail, appear reasonable and generally consistent with recent experience. According to the Business Plan, these trends, coupled with the

(a) Consistent with Lazard's obligations under its non-disclosure agreement with the Postal Service, all of the factual statements contained herein are based on the public statements and disclosures of the Postal Service, including its public financial statements, the public testimony of its leadership and the "Plan to Profitability – 5 Year Business Plan" publicly disclosed by the Postal Service on February 16, 2012, and other public documents. In connection with its work, Lazard has also met with and/or interviewed outside postal experts and users of Postal Service products and services as well as conducted its own independent financial analysis of the Postal Service based on its public statements and disclosures.

required pre-funding of future retiree health benefits at over $5 billion a year, will result in projected losses of over $80 billion during the forecast period, including a loss in the final year (2016) of over $20 billion.

The Business Plan proposes a number of strategic initiatives designed to restore the Postal Service to near-term solvency including:

- **Return of the Postal Service surplus in the FERS federal pension system**
- **Repeal of current legislative requirements that the Postal Service "pre-fund" obligations to the Retiree Health Benefit Fund (estimated 2016 annual savings: $5.8 billion)**
- **Reduction of service standards and other changes associated with sorting and transporting mail (estimated 2016 annual savings: $4.1 billion)**
- **Significant changes in the way that mail is delivered to U.S. households, including dramatically expanded use of curbside and centralized delivery (estimated 2016 annual savings: $3.0 billion)**
- **Elimination of Saturday delivery (estimated 2016 annual savings: $2.7 billion)**
- **Various "retail" initiatives, including the elimination of post office branches (estimated 2016 annual savings: $2.0 billion)**
- **Health care benefit reform (approximately $1.5 billion of estimated annual savings)**

Based on the Business Plan, these proposed initiatives, together with the refund of the FERS surplus show, on paper, that the Postal Service returns to profitability by 2016.

Delivering Change to the Postal Service

Areas of Common Ground

As noted above, we are skeptical of the Business Plan's unitary focus on cost cutting and a "shrink to survive" approach. That said, certain of the proposed initiatives, if they were a part of a more balanced and comprehensive plan, may make sense. For instance, the current legislative requirement that the Postal Service pre-fund its retiree health obligations is both financially punitive and entirely inconsistent with accepted practices within the private sector. The Postal Service has pre-funded over $21 billion in retiree health obligations over the past five years – funds which could have been used for investments in new services, technology, and operational restructuring initiatives. Similarly, refunding the billions of dollars of Postal Service surplus that is currently contained in the FERS pension fund seems reasonable based on third-party actuarial analysis. Enacting legislation that provides for these changes appears both appropriate and financially prudent as part of a broader plan of shared sacrifice. If properly structured, the changes to the Postal Service's health care plans also appear reasonable. Changes to the postal network, if done in a way that maintains its overall strength and balanced with revenue initiatives in a comprehensive plan, should be examined as well.

Leveraging the Strength of the Network

In our experience, we have not seen a business plan that uses reductions in service and product quality as the cornerstone of a successful turnaround. The Postal Service's proposed modifications – termination of Saturday delivery, a significant curtailment of "to the door" delivery and other reductions in service standards – could easily reduce demand by an amount equal to the alleged cost savings being discussed. In fact, one of the Postal Service's own witnesses at a Postal Regulatory Commission hearing on its network optimization plan recently acknowledged the existence of a study that found that the combined effects of all service cuts under consideration would reduce mail volume by over 10% – an amount which would offset most of the proposed savings from these initiatives.

Fundamentally, we believe that a successful restructuring of the Postal Service must start with a plan to better leverage its unrivaled last-mile delivery network – a retail network that touches every city, town and neighborhood in America. Instead of focusing on shrinking its network and capabilities, the Postal Service needs an ambitious rethinking of its business model. For example:

- **Better leverage last-mile delivery to grow the parcel service business**
  - Despite ever-increasing online retail purchases by consumers and rapidly growing e-commerce, the Business Plan assumes that volumes associated with "Shipping Services & Other" (i.e., parcel services) will actually *decrease* from 2011 to 2016. Assuming only modestly more aggressive growth targets for the Postal Service's parcel delivery business – consistent with implementation of a more forward- looking approach to sales, marketing and overall management of the Postal Service's parcel business – could result in substantial incremental revenue and profits.
  - Moreover, given the unparalleled strength of the Postal Service's last-mile delivery network, we believe the Postal Service could be exploring new and innovative delivery services that may add value for its customers. For example, the Postal Service expects to offer full "track and trace" capabilities by the end of 2012. This could provide the Postal Service with the opportunity to add, among other things, more competitive ground and expedited products comparable to those that have been successful in the private sector. The Postal Service has also begun to test new mail products such as saturation mail and the expansion of direct mail offerings to small business customers. These initiatives are a start but will require far more aggressive roll-out and many more such ideas to better leverage the Postal Service's last-mile advantage.
- **Explore expansion of services that the Postal Service can provide**
  - The Postal Service operates under constraints imposed on its business by the Postal Accountability and Enhancement Act of 2006. In the interest of ensuring that the United States has a postal institution that is self-sustaining and capable of fulfilling its public mission, we believe that the Postal Service and policymakers must consider expanding the

products and services that the American people would most value. Most leading postal services in the world (and their governments) have embraced some level of business diversification in a manner that is consistent with the postal mission but adequately protective of the private sector. In Germany, for instance, the postal service has privatized and expanded into businesses such as logistics and freight forwarding. And in the United States, as recently as the late 1960s, the Postal Service operated a postal savings system that provided depositories for working class citizens and immigrants accustomed to similar programs in their native countries.

- **Consider modifications and greater flexibility to pricing of products**
  - Notwithstanding a geographic footprint that is considerably more dispersed than other countries, the Postal Service provides Americans with unparalleled last-mile delivery service of both first class mail and parcels. With respect to first class mail, the Postal Service offers Americans among the most affordable postage rates in the world – significantly lower than comparable foreign posts[a] and indexed at a rate of inflation considerably lower than the distribution cost index that its private-sector competitors use to adjust their own pricing. With respect to Postal Service parcel products, many offerings (both market dominant and competitive) are priced in a manner that frequently ignores the highly dynamic and fluid nature of the modern parcel delivery business. In the context of shared sacrifice and development of a truly comprehensive business plan, we believe that adjustments to the pricing of regulated products and greater flexibility in the pricing of unregulated products are variables that merit further evaluation.

Senate Bill S. 1789 Is a Stop-Gap, Not a Solution

Lazard's review of the "Plan to Profitability" also included the review of various legislative proposals, including the most recent Senate bill S. 1789, the 21st Century Postal Service Act. S. 1789 is a well-intentioned proposal that may allow the Postal Service to survive for a few more years but it does not address its fundamental challenges. It accepts the Postal Service's business model when a fundamental re-thinking is what is required.

In private sector restructurings, successful turnarounds are generally premised on (i) a strategic plan that aims for a sustainable and viable enterprise and (ii) a management team and governance structure that is capable of executing that plan. Those two elements are developed first and then the necessary capital is secured. Unfortunately, this legislation provides the Postal Service with capital without either of these two elements being in place. Even worse, by adopting the Postal Service's proposals to reduce the quality and value of the services it provides to American households, it may actually accelerate the Postal Service's decline.

(a) In Canada, for instance, the current cost of a first-class stamp is \$0.61/stamp (over 35% higher than the U.S.). In the United Kingdom, it is \$0.72/stamp (60% higher than the U.S.). In other Western countries the current cost per first-class stamp is even higher.

There is little in the proposed legislation that addresses potential expansion of services, more flexible product pricing or necessary changes to the Postal Service's oversight and governance – all key elements of a comprehensive plan to create a sustainable and viable Postal Service.

S. 1789 also continues, albeit in a slightly modified form, the requirement to pre-fund retiree healthcare obligations and does not address the substantial and independently verified CSRS surplus which the Postal Service is owed. In this respect, S. 1789 deviates fundamentally from prior proposed legislation – S. 1010 and S. 353 (authored, respectively, by Senators Carper and Collins), both of which provided for the recalculation of surplus retirement funds in the Postal Service's CSRS account and the transfer of that surplus in order to defease the unfunded liability for future retiree health benefits and permanently end the retiree health pre-funding requirement. Recent independent audits of the postal sub-account of the CSRS conducted by respected private-sector employee benefits firms (The Hay Group for the Postal Service's Office of the Inspector General and the Segal Company for the Postal Regulatory Commission) each concluded that the pension allocation methods used by the Office of Personnel Management implied a postal surplus of between $50 and $75 billion. In an October 2011 report, the General Accounting Office stated that each of the pension accounting methodologies – Office of Personnel Management's, The Hay Group's and Segal Company's – were "reasonable" and indicated that the choice of which accounting method to use was a "policy decision" for Congress.

We believe the Senate should make that policy decision and adopt the more modern, private-sector methods used in The Hay Group and Segal Company audits. Otherwise, it should suspend the pre-funding mandate until a new business model for the Postal Service can be developed. As drafted, the proposed S. 1789 does neither.

From our perspective as private sector restructuring professionals, S. 1789 is not a proposal that provides a roadmap to long-term postal viability. It is a stop-gap measure that facilitates the Postal Service's "shrink to survive" plan. The Postal Service requires legislative relief and such relief may well be in support of a business plan that includes reductions in headcount and labor costs. But the plan must also be based on the vigorous pursuit of new revenue opportunities, the expansion of services, pricing flexibility and strategies that leverage, not impair, the value of the last-mile network.

Shared Sacrifice and a New Vision

A key theme of virtually every successful private-sector restructuring is shared sacrifice – by customers, creditors, management, employees, and all other stakeholders. We believe that this principle is equally applicable if there is to be a successful restructuring of the Postal Service.

The current Business Plan is one that is largely based on one-sided employee sacrifice leading to the loss of jobs and benefits and critically the degradation of the last-mile network. Delivering a vibrant and growing Postal Service requires a more balanced and independent assessment that would likely result in a more balanced mix of initiatives.

Consistent with a comprehensive rethinking of the Postal Service premised on shared sacrifice, the current governance and regulatory framework of the Postal Service should also be evaluated. The current governance structure, which has been in existence since 1971, does not appear to be consistent with a rapidly moving digital society and the need for bolder strategic thinking to better leverage this national asset. The restructuring of the Postal Service requires a rethinking of the institution that focuses on new opportunities instead of old problems and seeks to proactively leverage the strengths of its network rather than reactively shrinking to survive.

Background

Lazard is a preeminent international financial advisory firm that has long specialized in crafting solutions to the complex financial and strategic challenges of our clients. We serve a diverse set of clients around the world, including corporations, partnerships, institutions, governments and high-net-worth individuals. Lazard and its senior professionals have extensive experience in the reorganization and restructuring of troubled companies and have advised debtors, creditors, equity constituencies and government agencies in numerous complex financial reorganizations. Since 1990, Lazard's professionals have been involved in over 250 restructurings, representing over $1 trillion in debtor assets. Lazard also has over 35 years of government advisory experience involving over 40 sovereign assignments.

Lazard was retained by the National Association of Letter Carriers ("NALC") in November of 2011 in connection with issues relating to the Postal Service. A team of Lazard professionals with extensive experience in providing restructuring advice undertook due diligence of the Postal Service beginning in early 2012.