OFFICE OF INSPECTOR GENERAL
UNITED STATES POSTAL SERVICE

Mail Profitability in International Posts

RARC Report

Report Number
RARC-WP-17-008

May 1, 2017

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UNITED STATES POSTAL SERVICE

Executive Summary

Letter mail still matters. In spite of years of volume decline, mail has remained, for most international posts, a remarkably resilient and profitable line of business. To understand why this is, the U.S. Postal Service Office of Inspector General, in collaboration with German research firm WIK-Consult, analyzed 13 international posts. The 13 were selected for the variety of their regulatory frameworks and market environments, as well as the availability of their data. Our analysis found that, despite their disparate situations, 11 of them — Austria, Belgium, Finland, France, Italy, Netherlands, Norway, Portugal, Singapore, Switzerland, and the United Kingdom — posted, on average, a positive annual profit margin for mail during the 5 years of analysis from 2011 to 2015. (Australia Post was the only non-profitable post, and Deutsche Post DHL changed the way they report mail profits.) Not only was mail a profitable business for these posts, it was a critical and material one. From 2011 to 2015, mail generated on average over 60 percent of their total profits.

The fortitude of mail derived from posts' ability to raise their revenue per mailpiece, lower their operating expenses, or both. External forces often boosted that ability. It is no coincidence that best performers benefitted from

- **Less restrictive legal and regulatory environments**. The freedom to raise prices above the rate of inflation is one critical factor that allowed posts to achieve and sustain profitability. Favorable labor and pension laws also helped.

- **Government support**. This support came in several forms, such as subsidies, debt relief, restructuring aids, tax credits, and transferring pension liabilities to the federal government.

Whether they enjoyed those benefits or not, international posts, when legally allowed, took a common approach to cutting costs. Workforce reduction, automation of mail processing, shrinking the number of post offices, and streamlining of sorting and delivery were the common methods used in almost every country — although with different timing and scope.

Changing market conditions threatened the profitability of mail in all 13 countries, but also provided opportunities in the form of efficiency-promoting technology. By combining such efficiencies, cost-cutting measures, and price increases, posts worldwide have been able to keep mail profitable. Even as the parcel market grows and posts prepare for a new future, mail remains essential to their financial viability today.

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Introduction

Weighed against a booming package delivery industry that is being driven by ecommerce, mail is often viewed as a dying legacy business for posts around the world. However, the financial results of many posts tell a different and more optimistic story. Though letter mail volumes are falling, for the most part posts have managed to keep their core mail business lines profitable. Mail's finances, it seems, have been surprisingly resilient.

The U.S. Postal Service Office of Inspector General (OIG) set out to determine exactly how important mail is to the overall financial picture of postal operators, what the main drivers of mail profitability are, and what lessons can be learned from international posts with a profitable mail business. To address these topics, the OIG partnered with WIK-Consult (WIK) — a German consulting firm with expertise in the global postal sector — to conduct a two-phase study.

The first phase compared the relative size and profitability of mail businesses at 13 major posts from around the world. The posts were chosen based on the availability of their data and a desire to include a variety of different regulatory and market environments.[1] The second phase of our study took a deep dive into five of these posts (Australia, Belgium, Germany, Switzerland, and the United Kingdom), chosen for the diversity of their circumstances. Our analysis took into account the strategies they have pursued to protect or grow the profitability of their mail businesses, as well as the main external factors affecting mail in their countries.

We primarily examined the 5-year period from 2011 to 2015, but also included earlier data where appropriate. We looked only at traditional mail — letters, flats, and small packets — while excluding parcels, express, and digital mail.[2] The main sources of information used were publicly-available reports — posts' annual financial reports complemented by data from national postal regulators.[3]

Some posts do not report mail profit separately, instead including it as part of a larger segment with parcels, retail, or digital services.[4] However, after conducting the analysis, we are confident that overall trends and directional conclusions from the available data are still reasonable and useful.

Mail Is Still a Critical Source of Revenue and Profits

A Declining but Still Substantial Share of Total Revenue

According to Accenture, mail as a percentage of revenue has declined for every major international post, from an average of 55 percent of revenue in 2004 to 44 percent in 2015.[5] However, this average masks wide variability across countries.

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1 Australia, Austria, Belgium, Finland, France, Germany, Italy, Netherlands, Norway, Portugal, Singapore, Switzerland, and the United Kingdom. We chose these posts because they reported mail separately for part or all of the years from 2011 to 2015. The exception is Germany, which we retained for two other reasons. First, because of the sheer size and significance of this operator. Second, because mail generates the majority (60 percent) of the revenue of its reported Post — eCommerce — Parcels (PeP) segment.

2 Unaddressed mail, a separate mail class in most foreign countries, is also included.

3 The OIG did not attempt to account for differences in the accounting principles and standards used by the different posts reviewed.

4 The U.S. Postal Service presents profit and loss (P&L) for its whole business, not for each individual segment. U.S. Postal Service, 2016 Report on Form 10-K, https://about.usps.com/who-we-are/financials/10k-reports/fy2016.pdf, p. 39. The Postal Service also publishes revenue and cost information for each mail class, using the method prescribed by the Postal Regulatory Commission. For each mail class, it calculates attributable costs and its contribution to institutional costs (revenue minus attributable costs). U.S. Postal Service, *Public Cost and Revenue Analysis — FY 2015*, http://about.usps.com/who-we-are/financials/cost-revenue-analysis-reports/fy2015.pdf.

5 Accenture, *Achieving High Performance in the Post and Parcel Industry,* 2016, https://www.accenture.com/t20151015T043945__w__/us-en/_acnmedia/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Dualpub_23/Accenture-Achieving-High-Performance-in-the-Postal-Industry-2015-V2.pdf, p. 7.

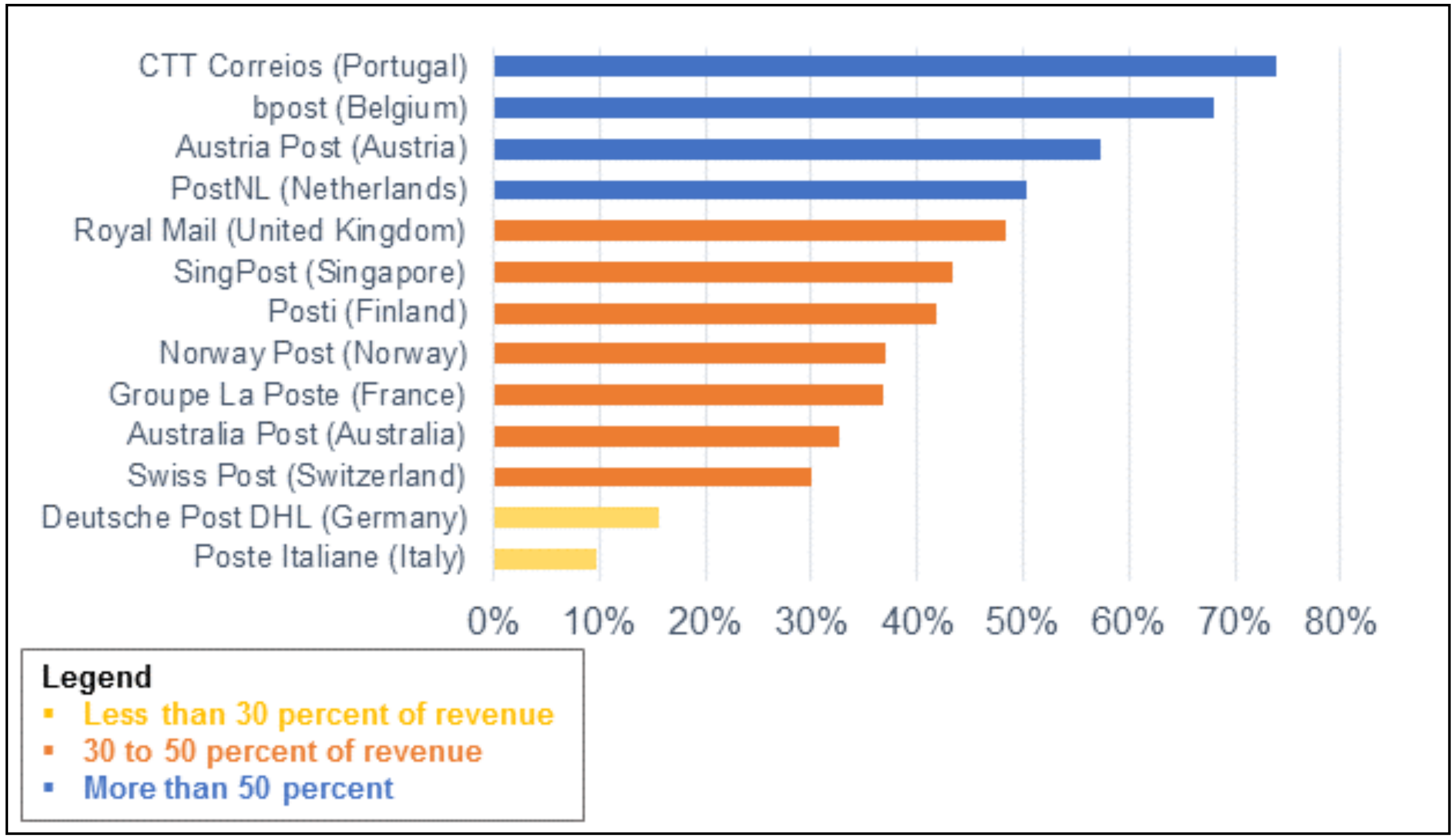
We classified the examined posts into three main categories based on the criticality of mail vis-à-vis their overall business (Figure 1):

- **Mail as the predominant business (over 50 percent of revenue).**[6] This category includes four traditional posts that still rely heavily on mail. The Portuguese post, CTT Correios, is the most mail-dependent: 74 percent of its revenue still comes from mail — about the same proportion as in the United States (73 percent).[7]

- **Mail as a substantial business (30 to 50 percent of revenue)**. This is the largest category — seven of the 13 countries we surveyed belong to it. These posts, such as France or Switzerland, typically have a highly diversified and balanced portfolio of businesses including logistics, banking, retail, and digital services.[8]

- **Mail as a marginal business (less than 30 percent of revenue).** For Poste Italiane (9 percent) and Deutsche Post DHL (16 percent), mail has taken a back seat to other businesses. Poste Italiane is primarily a financial and insurance company, and Deutsche Post DHL is a global logistics group.

Figure 1: Mail Revenue as a Percentage of Total Revenue (2015)



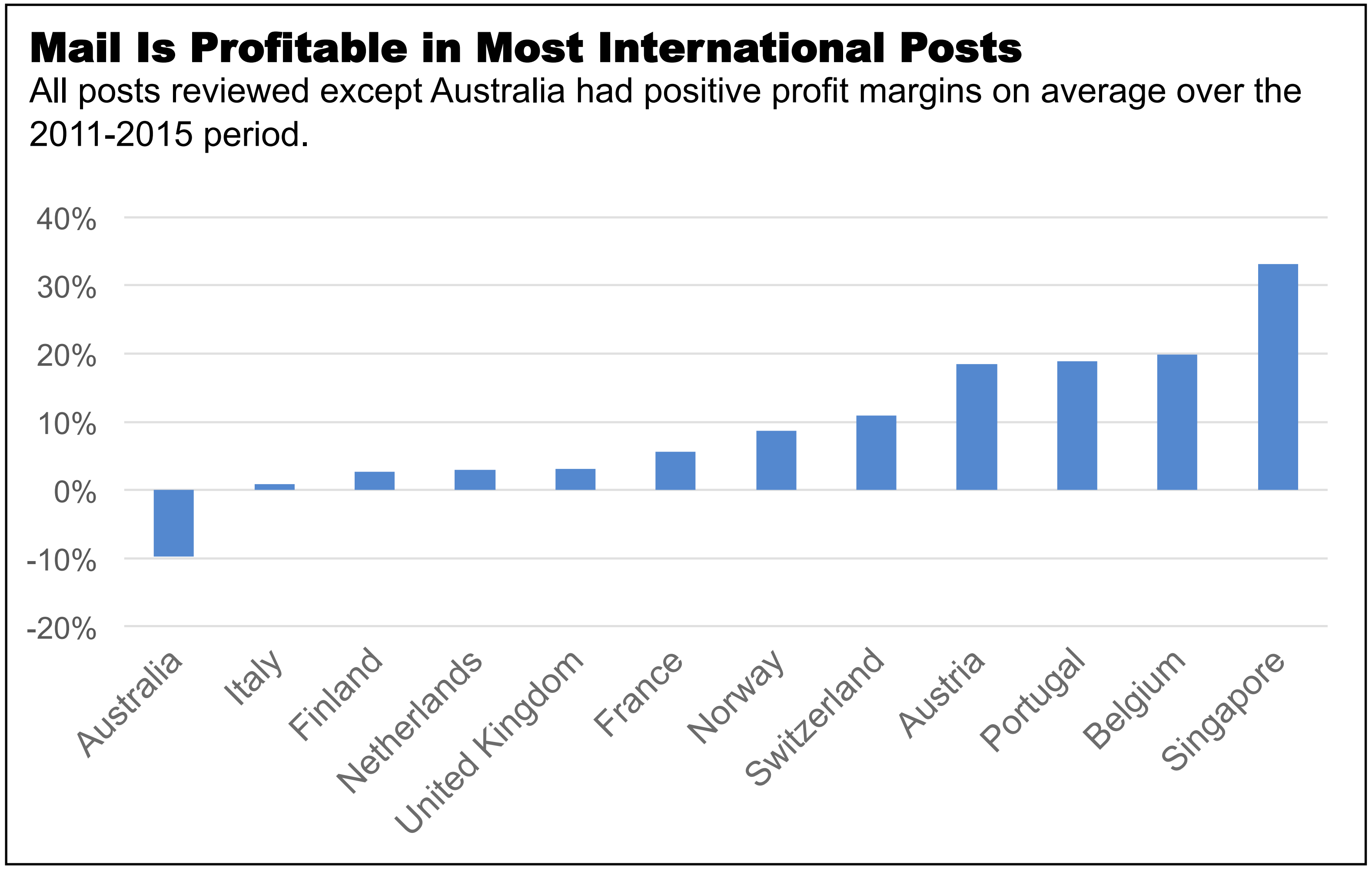
Source: WIK and OIG analysis.

6 Percentages shown in Figure 1 may slightly differ from those reported by a post for its mail business unit, where this unit includes other products and services in addition to mail.
7 However, the recent creation of a postal bank (Banco CTT) could reduce the mail's share of the Portuguese post's total revenue.
8 Swiss Post also has a sizeable local bus division that makes up 10 percent of its revenue.

Mail Generates Sustainable Profits

We also looked into mail profitability over the past 5 years (2011-2015). To compare profitability, we used Earnings Before Interest and Taxes (EBIT) and calculated a 5-year average.[9] What we found is that all of the posts, except Australia Post, showed positive mail EBIT margins on average over this period (Figure 2).[10] SingPost was the most profitable, with an average profit margin over 30 percent.

Figure 2: Mail Profitability: Average EBIT Margin (2011-2015)

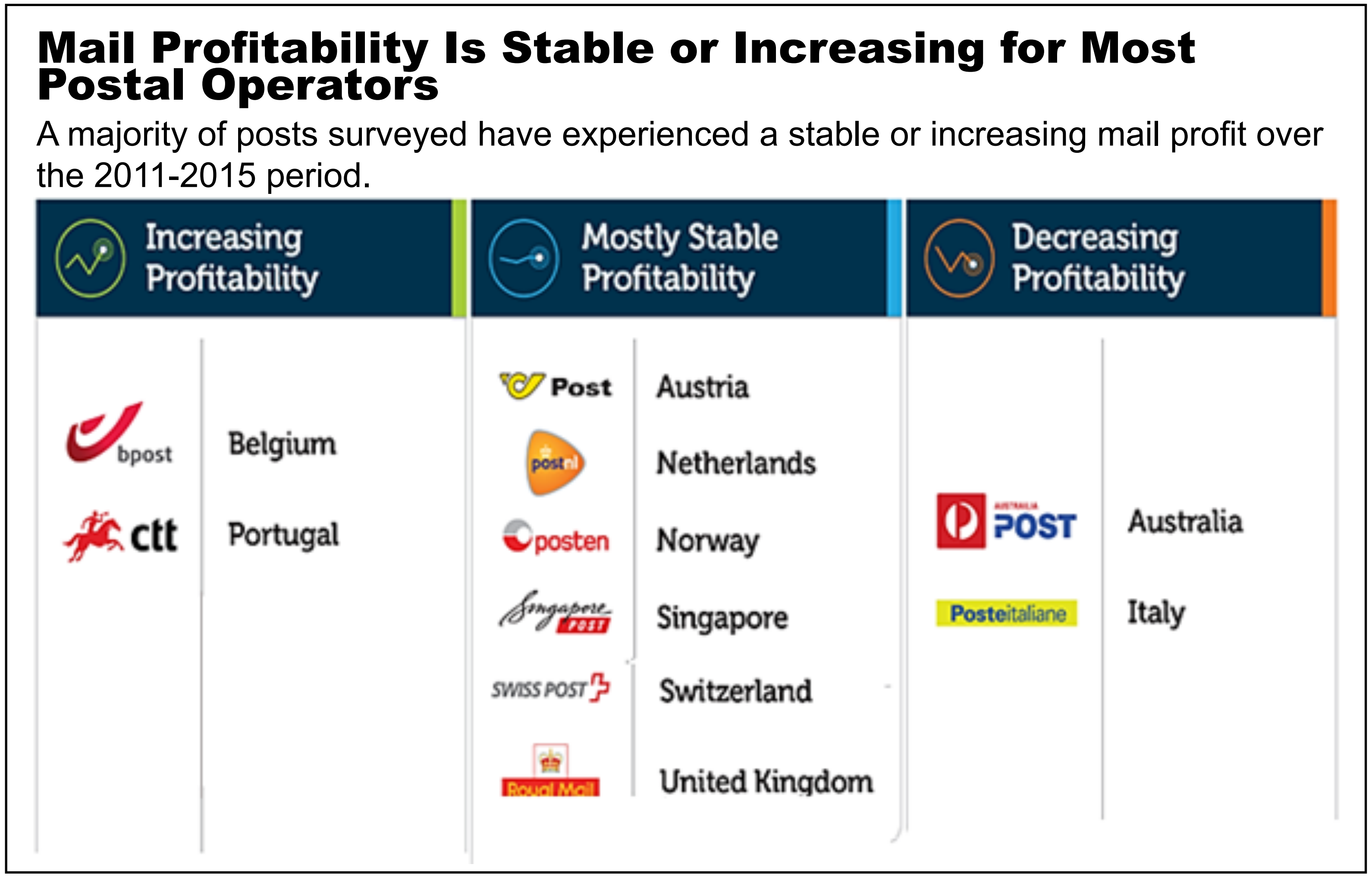


Source: WIK and OIG analysis.

9 EBIT is the difference between the revenue generated by operations and operating expenses, before interest and tax are applied.
10 Figure 2 is based on the following sources: for Australia Post, Posti (Finland), PostNL, and Swiss Post, EBIT of mail operations/total addressed mail revenue; for Austria, EBIT of mail and network branch/revenue of mail and network branch without inter-segment sales; for bpost, EBIT of Letter Mail and Retail Solutions/revenue of Mail and Retail Solutions; for Groupe La Poste, EBIT of the mail and domestic B2C parcels branch/ revenue of the branch; for Singpost, operating profit of the Mail division/ total revenue of the Mail division; for CTT Correios, EBIT of the Mail branch/external revenue of the Mail branch; for Norway Post, EBIT of the Mail division/revenue of the division; for Royal Mail, Financeability Reported Business EBIT Margin as published by OFCOM; for Poste Italiane, EBIT of the Postal and Business Services division/ total EBIT of the division. Data for France is a 3-year average (2011-2013) and for Finland a 4-year average (2011-2014). Finally, Germany is not included, as the scope of the Mail segment (now PeP segment) has significantly evolved over time.

Regarding trends over time, the majority of posts maintained their mail profits over the 5-year period and two (Belgium and Portugal) have actually increased it (Figure 3).[11] Only the Australian and Italian posts showed a declining trend.[12]

Figure 3: Mail Profitability Trends (2011-2015)



Source: WIK and OIG analysis.

In addition to looking at mail profitability trends on their own, we compared the total amount of profits generated by mail in relation to the posts' other businesses. We found that mail still represented, on average, about 62 percent of total profits (Figure 4). In fact, mail represented the single largest source of profits in eight of the 13 posts.[13] At three posts (Austria, Netherlands, and Norway), it was the *only* source of profits over the period.[14] The countries where mail was not the largest profit segment were those with strong financial services or logistics businesses (Italy, Germany), highly-diversified business portfolios (France, Switzerland), or a mail business that produces no profits at all (Australia).

11 Finland, France, and Germany are not shown in Figure 3 as the scope of their reported mail segment changed significantly from 2011 to 2015.
12 Australia Post has since reduced losses incurred in monopoly services (letters) from A$284 million ($218 million) in FY 2015 to only A$14 million ($11 million) in FY 2016. Australia Post, *Part of Tomorrow - Australia Post Annual Report 2016*, http://auspost.com.au/annualreport2016/resources/docs/auspost_annual_report.pdf, p. 11. Poste Italiane's mail evolved from a robust 16.5 percent EBIT margin in 2011 to significant losses in 2014 and 2015. Losses incurred in 2014 were partly the result of a 10 percent decrease in mail volume the year before. The Mail and Business Services division returned to profitability in the first half of 2016 with an EBIT margin of 1.7 percent. Poste Italiane highlighted "a slowdown in revenue decline" and "the positive impact of new pricing" as the main reasons for improvement. Poste Italiane, *First Half 2016 Results*, August 2, 2016, http://www.posteitaliane.post/resources/editoriale/pdf/investitori/presentazioni/Analyst-Presentation-1H-2016-final.pdf, slides 17 and 28.
13 In one of the eight, Royal Mail, mail is reported together with domestic parcels.
14 Parcels divisions generally include revenue not only from parcels delivery but also from adjacent services, such as ecommerce logistics.

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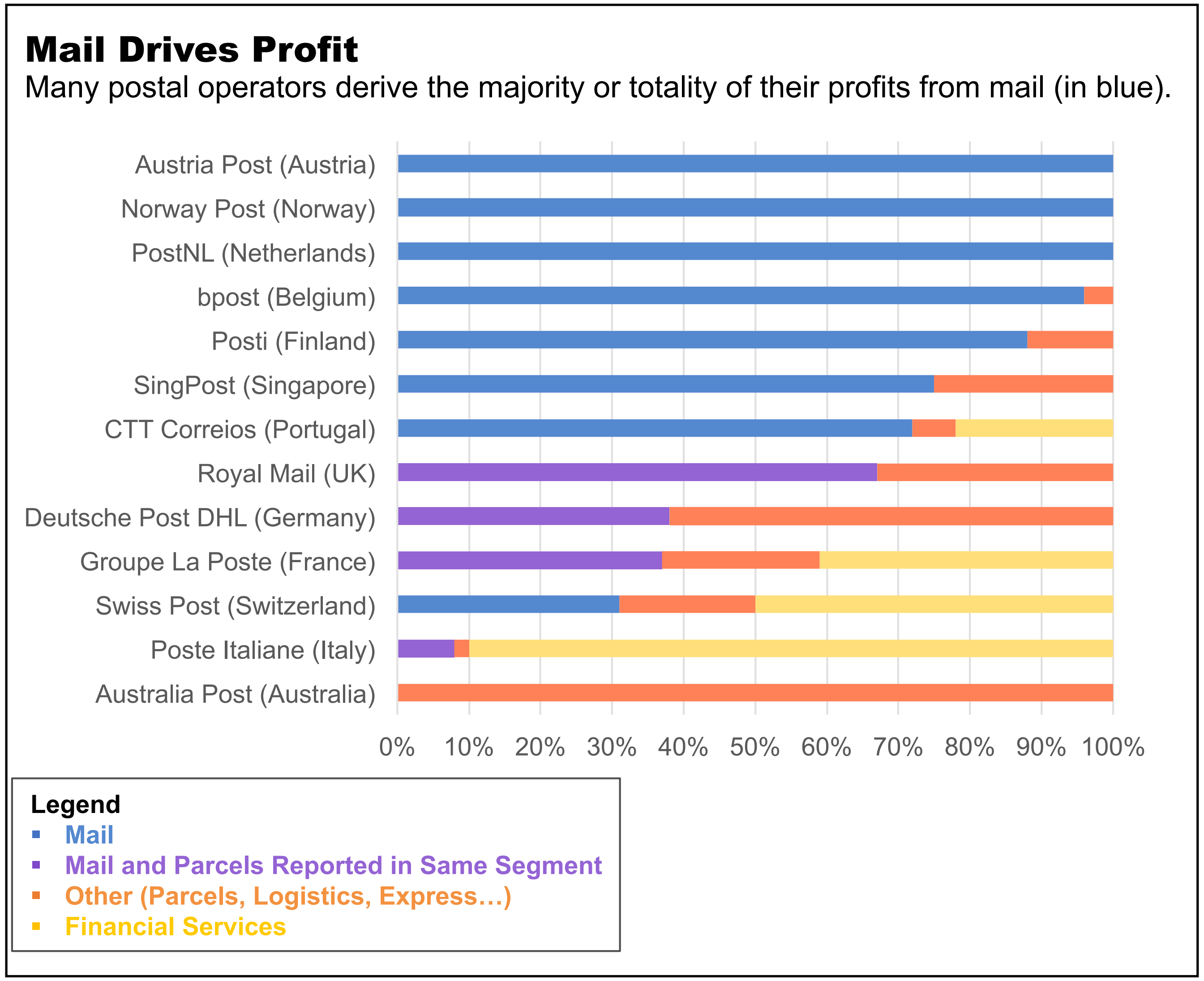
Figure 4: Cumulated Profits — Breakdown by Segment (2011-2015)



Source: WIK and OIG analysis.

Comparing EBIT margins for mail to those of other segments, we found that:

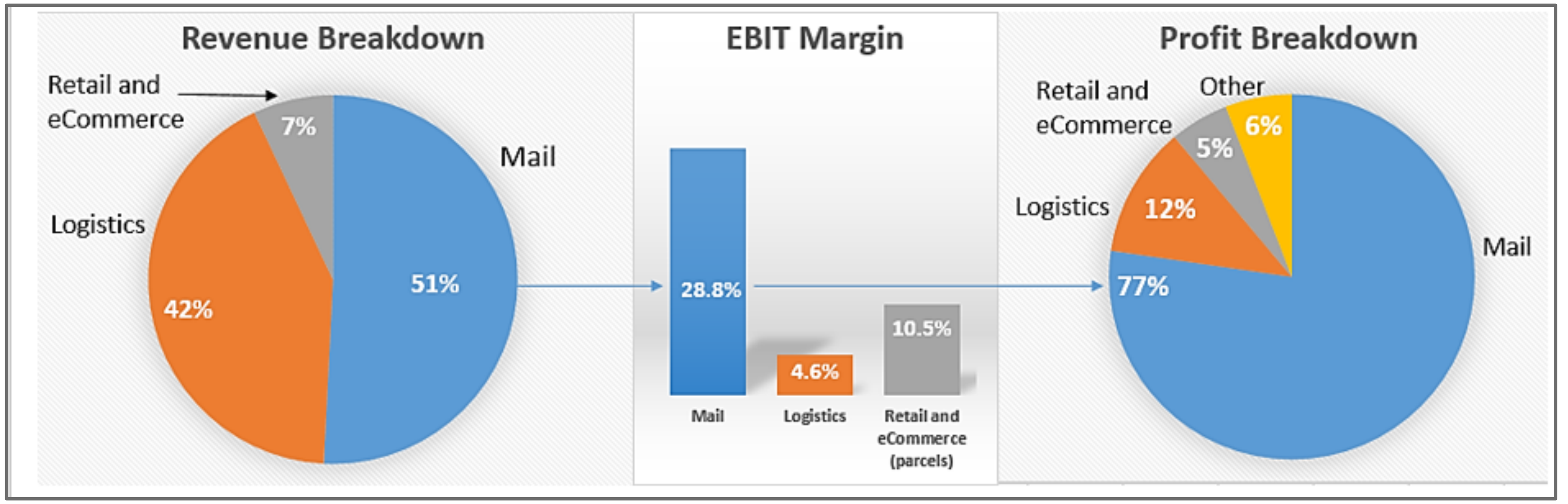
- **Mail's profit margin is considerably lower than financial services'**. This is the case in the four countries that report financial services separately. Financial services is at least twice as profitable as mail in Switzerland and Portugal and 10 times as profitable as mail in Italy.[15]

- **Mail's profit margin tends to be higher than parcels' and logistics'.**[16] From 2011 to 2015, the mail division of seven postal operators was more profitable than the parcels and logistics divisions.[17] The opposite was true only in Australia, where the post's parcels and logistics business turned a 13.6 percent profit while mail lost money.

15 For France the mail EBIT figure includes mail and domestic B2C parcels; for Italy, mail and all parcels.
16 This analysis was possible only for the nine countries that published separate profit and loss statements for mail and parcels over the review period. France, Germany, Italy and the United Kingdom were not considered.
17 The mail divisions of the posts in Austria, Belgium, Finland, Netherlands, Norway, Singapore, and Switzerland were all more profitable than their parcels divisions. In Austria, the international parcels business Trans-O-Flex, which ended up being sold, was the main reason for losses in the parcels business. In Finland, the international road freight business drove down the parcels and logistics' division profits for several years and was also sold off in 2015.

Singapore, where the Mail segment's EBIT margin is seven times higher than the Logistics segment's, is an interesting case. Even though SingPost fashions itself as a regional logistics and ecommerce leader, it still earned over three quarters of its profits from mail in 2015 (Figure 5).[18]

Figure 5: SingPost (Singapore) Revenue and Profit Breakdown (2014/2015)



Source: Singapore Post, *Going International, Singapore Post Annual Report 2014/2015*, http://www.singpost.com/sites/default/files/publications_file/2016/07/ar201415_7.pdf, p. 26.

While further declines in mail volumes may reduce the strategic importance of mail in the future, this core postal activity today remains, with a few exceptions, a critical source of revenue and profits.

The Main Drivers of Mail Profitability

The second phase of the research consisted of analyzing the factors that drive mail profitability. To accomplish this, we drilled down into a subset of five posts: Australia Post, bpost, Deutsche Post DHL, Swiss Post, and Royal Mail. These five were chosen because they represent a mix of different sizes, have different levels of profit and diversification, and operate in different legal environments. We studied these posts' price and cost efficiency strategies, labor policies, and pension reforms. This section explores each of these in turn, focusing on the 2011 to 2015 period but occasionally going back to 2007 to review longer-term trends.

These strategies are discussed within the context of the national legal and regulatory framework in which each post operates. In many cases, a flexible regulatory environment coupled with government support was a major factor in allowing posts to shore up their finances.

18 The share of mail has declined to 41 percent of total revenue in FY 2015/2016 owing to growth and acquisitions in logistics and ecommerce. However, mail remained the most profitable division, and still generated 52 percent of profits. Singpost, *Transforming for the Future - Singapore Post Annual Report 2015/2016*, http://www.singpost.com/sites/default/files/publications_file/2016/07/Singpost%20AR15-16.pdf, p. 32.

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One contextual factor not addressed in this paper is privatization. In fact three of the five posts reviewed are privatized.[19] Privatization can have a sizable impact on profitability because of the way it puts pressure on management to reward shareholders.[20] Since in our view privatization is not a strategy itself but rather accelerates other actions that increase revenue or cut costs, we did not specifically address it.[21]

Greater Pricing Flexibilities

Having the flexibility to raise prices as needed is crucial for profitability. It allows posts to increase revenue, which in turn improves profits.[22] Four of the posts — Switzerland being the exception — operate within relatively flexible pricing schemes. These posts enjoy little to no price restrictions except on single-piece mail, which is typically a lower volume product regulated through price caps to protect its affordability.[23]

Price Increases Raised Revenue

Four posts currently enjoy pricing flexibility: Australia, Belgium, Germany, and the United Kingdom. Swiss Post does not. Twice in the past 3 years the Swiss regulator has frozen mail prices at their current level — a moratorium that extends until the end of 2017.[24] Relying on the low elasticity of mail volumes — whereby price increases do not cause corresponding drops in volume — the remaining four posts have leveraged their pricing flexibility to pursue two strategies:[25]

- **Price increases above inflation**: Royal Mail, Deutsche Post DHL, and bpost used this strategy. For example, Royal Mail's prices for single-piece 1st Class (small and large) letters have increased on average by 7.3 percent a year since 2007, more than three times the average inflation rate of 2.3 percent.[26]

- **Changing the delivery standards for certain letter products**. In early 2016, in addition to raising the stamp price, Australia Post introduced a two-speed product structure. Australia Post downgraded service standards for the regular letter product and, in parallel, introduced a new "priority" product that could be delivered faster for a surcharge. Australians now have to pay more than double to receive the same service they used to get at the regular letter rate.

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19 Deutsche Post DHL and bpost are partially privatized, and Royal Mail is fully privatized. Australia Post and Swiss Post are fully government-owned.

20 International Post Corporation has found that "[stock exchange] listed posts [have] generally achieved a high level of profitability over the last three years, generating EBIT margins four times those of unlisted operators on average." International Post Corporation, *Global Postal Industry Report 2015*, p. 24.

21 The effect of privatization on profitability will only be favorable if the post privatizes successfully. In the past, the privatization of financially weak posts was problematic (Lebanon), repeatedly delayed (Romania), or, at worst, disastrous (Argentina).

22 For a detailed description of price regulations internationally see OIG, *Lessons in Price Regulation from International Posts*, Report No. RARC-WP-17-003, February 8, 2017, https://www.uspsoig.gov/document/lessons-price-regulation-international-posts.

23 Single-piece mail is generally part of the universal service, which must be offered at "affordable prices." The price of other types of mail, such as bulk mail, may be set by the post based on market conditions. However, the regulator or competition authorities may still review those prices.

24 The Swiss Price Oversight Agency has argued that owing to its high profitability, Swiss Post did not need the additional revenue price increases would bring and did not allow them. Conseil Fédéral, "Le Surveillant des prix et la Poste s'accordent sur une prolongation de principe du réglement amiable conclu en janvier 2014 (moratoire sur les prix) et sur d'autres allègements tarifaires," *Swiss Parliament web site,* July 5, 2016, https://www.admin.ch/gov/fr/start/dokumentation/medienmitteilungen.msg-id-62524.html.

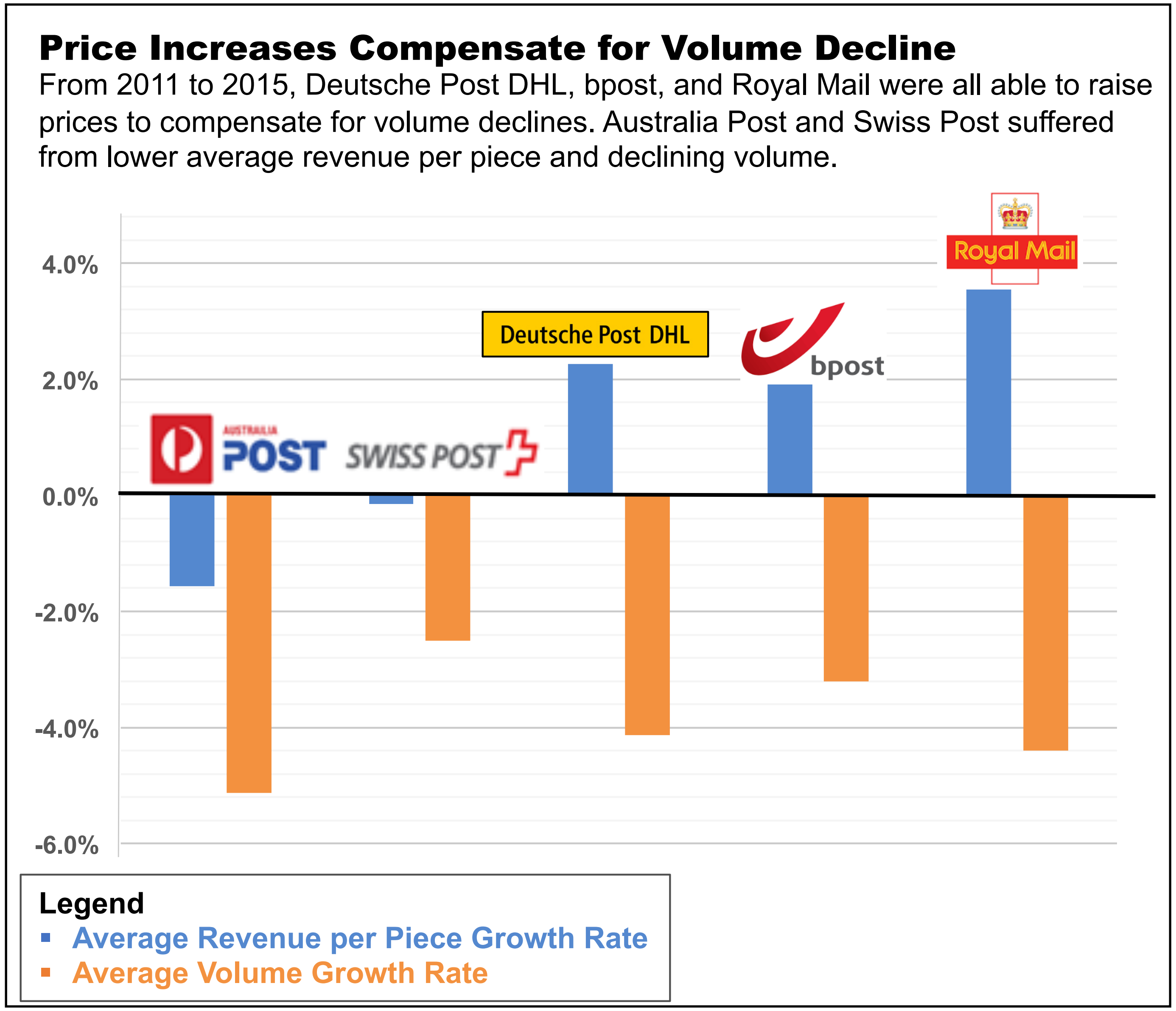
25 For example, econometric studies have concluded that in Australia, price did not explain falling volumes. Australia Post, *Draft Price Notification Changes to Australia Post's Ordinary Letter Service*, August 2015, https://www.accc.gov.au/system/files/Draft%20Price%20Notification.pdf, pp. 24-33.

26 Please note that the 7.3 percent average corresponds to a one-time 30 percent increase in 2012 followed by small increases in 2014 and 2015.

Price Increases Have Partly Compensated for Volume Decline

From 2011 to 2015, the letter mail volumes at all five operators declined, albeit at different rates (Figure 6). For example, the rate of volume decline was much lower in Switzerland than in the United Kingdom or Australia.

Figure 6: Trends in Average Revenue Per Mail Piece and Mail Volume Annual Growth Rate (2011-2015)



Source: WIK.

The United Kingdom, and to some extent Germany and Belgium, have compensated for the harm of their volume declines with price increases. Their mail revenue dropped less than 2 percent a year as a result. Revenue loss was also contained in Switzerland thanks to a more resilient mail demand. In Australia, the combination of steeper volume declines and a decrease in the average revenue per piece had a very negative impact on revenue.[27] This led the post to introduce the two-tiered pricing structure mentioned previously.

27 One reason for Australia's declining revenue per piece may be a changing product mix, with higher-priced standard letters declining faster than lower-priced Presort letters.

Flexible Labor Policies

Labor represents a substantial cost to posts, often accounting for a half to two-thirds of all operating expenses. While this labor cost is for the post as a whole and not for the mail unit specifically, processing and delivering the mail represents a substantial portion of labor costs for most posts.[28] Therefore, reductions in labor cost, all things equal, will affect mail profits. Where allowed under national labor laws, the five posts reduced workforces through attrition, two-tier wage and benefit systems, or both.

Posts Have Reduced Workforce Size

The reduction of workforce size has been a long-term trend. The total number of employees at the five posts has decreased at an average rate of 1.5 percent per year since 2007. Aging workforces — a large portion of which is age 50 or above — enable the posts to cut the number of employees by attrition rather than layoffs. These posts have also encouraged early or partial retirement.

Deutsche Post DHL started shrinking its employee rolls as early as the late 1980s. Bpost started much later — in the mid 2000s — and has reduced its total number of employees by 34 percent between 2005 and 2015. It relied on attrition until its 2015 Alpha Plan, which initiated a round of layoffs that was largely unprecedented for a major post (Box 1). By comparison, Australia Post has only recently introduced an ambitious plan to cut its staff by 9 percent by 2018.

Box 1: Streamlining Jobs — bpost's Alpha Plan

In 2015, bpost set out to streamline its central administrative staff, which represented 4 percent of its total workforce. Employees were required to re-apply for their position or apply for another one. Bpost and its labor unions agreed to provide “special arrangements,” usually job retraining or severance, for employees who would not be re-hired or who wished to leave the company or take early retirement.

At the end of the process, bpost was able to reduce its central administrative employee roster by 30 percent without massive layoffs. Ten percent of employees retired and 13 percent resigned. The remaining 7 percent (people who re-applied for the job they previously held but were not selected) were laid off — an unusual move for a post.

Two-Tier Wage Systems Have Reduced Average Costs per Employee

In addition to reducing the labor force, some posts were able to introduce a two-tier wage system to decrease labor costs. Under such a system, posts hire new employees at a lower pay scale than existing employees, who maintain the original, higher, pay scale. Deutsche Post, in keeping with its role as an early reformer, introduced a two-tier system back in 2001 for all new carriers, drivers, and sorting center employees. Since 2010, bpost has been progressively replacing higher-cost employees (such as civil servant letter carriers) with “auxiliary” employees costing 30 percent less (Figure 7).[29]

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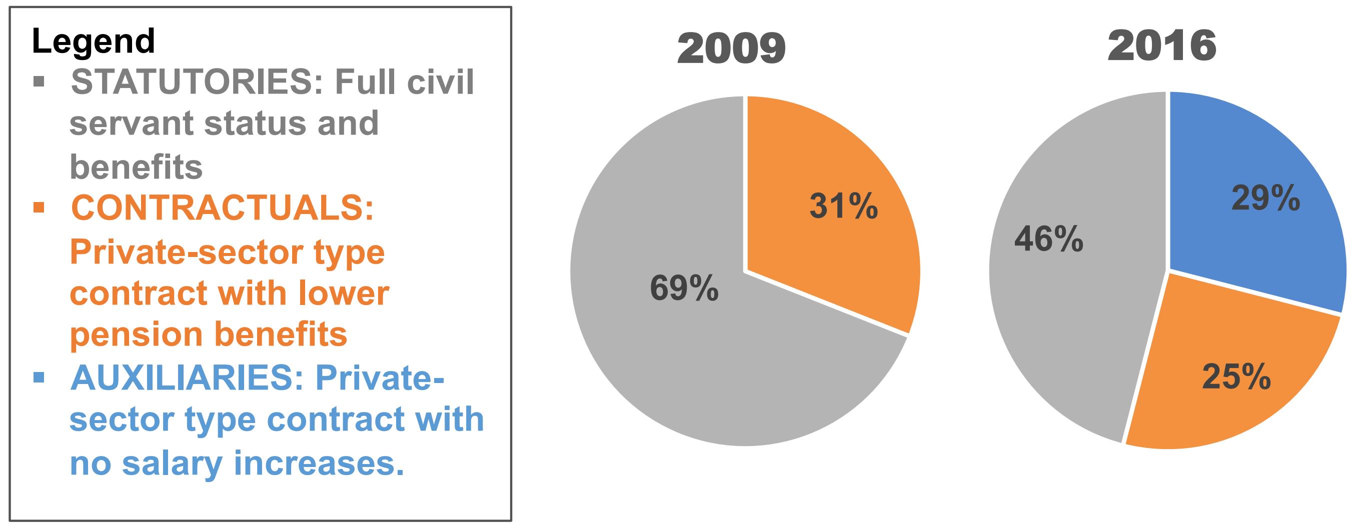
28 Most postal operators do not publish data about the allocation of labor costs to specific units. Where they do, though, we can see that mail makes up a sizable portion of the labor force — for example 37 percent at Swiss Post (a highly diversified operator) and 50 percent at Australia Post. See Swiss Post, *Financial Report 2015*, http://geschaeftsbericht.post.ch/15/ar/downloads/geschaeftsbericht_konzern/en/E_Post_GB15_Finanzbericht_WEB.pdf, p. 35, and Australia Competition and Consumer Commission, *Australia Post's Draft Price Notification Issues Paper*, September 7, 2015, https://www.accc.gov.au/system/files/australia%20post%202015%20price%20notification%20issues%20paper.pdf, p. 17.

29 Auxiliary postmen is the term bpost uses for postmen with private-sector contract on lower salaries. Bpost, *With confidence bpost annual report 2015*, 2015, http://corporate.bpost.be/~/media/Files/B/Bpost/annual-reports/bpost%20annual%20report%202015_EN.pdf.

Figure 7: bpost Contract Types and Relative Employee Cost

bpost Has Replaced Civil Servants with Cheaper Auxiliary Employees

Until 2010, most letter carriers in Belgium were civil servants. As they retire, bpost now replaces them only with lower-paid “auxiliary” employees costing 30 percent less. “Auxiliaries” currently make up 29 percent of the workforce.



Source: bpost.

However, country-specific labor laws and existing collective bargaining agreements affect workforce reduction strategies. For example, Swiss Post is constrained by laws that prescribe a “same job, same wage” policy, prohibiting two-tier pay scales for the same function. Swiss Post is also mandated to protect jobs — for example, it cannot entrust a third party company with the provision of universal services.[30] As a result, its total number of employees has been quite stable over the past 10 years.[31] In the United Kingdom, the collective bargaining agreement requires two-thirds of the workforce to be full time and prohibits core operational functions from being outsourced.[32]

Measures to Reduce Pension Costs

Payroll is not the only labor-related cost that affects mail profits. Prefunding pension liabilities for retirees can be a major expense as well. Some posts pay all of these expenses out of their own pension funds, which, should they become underfunded, requires the post to make up the difference. In other countries, the post contributes to employees’ pension plans but the government pays out all pension expenses.

30 However, since 2012 Swiss Post is allowed to use subcontractors. Federal Department of the Environment, Transport, Energy and Communications, *Postorganisationsverordnung VPOG vom 24. Oktober 2012 - Erläuterungsbericht*, October 24, 2012, http://www.postcom.admin.ch/de/publikationen/Erlaeuterungsbericht-Verordnung-Postorganisationsgesetz-20121024-D.pdf.

31 While the post announced in 2016 it would close up to 600 post offices in the coming years and possibly cut 1,200 jobs, CEO Ruoff insisted this would be done through attrition and, as much as possible, not through terminations.

32 Functions that cannot be outsourced include: Royal Mail Delivery, Processing, Network, Collections, Engineering, Fleet & Maintenance Services, Royal Mail Specialist Services, Manual Data Entry Centers, Mail Screeners, Human Resources, Finance and Information, Technology Functions, and Customer Experience. CWU, *Agenda for Growth, Stability & Long Term Success,* January 2014, http://www.cwu.org/assets/cwu/legacy-assets/documents/jan_14/cwu__1389094257_04273_Agenda_For_Growth_Stabil.pdf, p. 7.

This situation is not always static. Three countries saw the government step in to alleviate or take over the post's pension liability burden:

- ***Belgium***. In 1997, the Belgian post transferred its pension liability to the government.
- ***United Kingdom***. In 2012, Royal Mail handed most of its pension liabilities and assets to the government.[33] This measure absolved Royal Mail of the need to make additional cash payments of about £300 million ($368 million) a year to address the deficit.[34]
- ***Germany***. Since 2000, Deutsche Post's pension costs for its civil servant postal employees are shared between the post and the German government.

However, offloading pension liabilities to the government has not been the only option. Posts have also changed the retirement plans' rules and benefits by, for example, creating a two-tier benefit system that reduces benefits for new employees. Both Royal Mail (in 2008) and Australia Post (in 2012) excluded new employees from their defined benefit pension plans.[35] In a defined benefit plan, retirees receive a specified amount in retirement. This means that the post bears the investment risk. In a defined contribution plan, by contrast, future benefits fluctuate based on investment earnings, transferring the risk to retirees.

Government's Direct or Indirect Support

Government support, either direct or indirect, substantially helps mail profitability. None of the five posts reviewed currently receives direct subsidies from government for the provision of mail universal service obligations (USOs).[36] However, they benefit from other forms of direct or indirect assistance that increase revenue or decrease operating costs or lower the tax burden. These include:

- **Compensation for public services**. For example, the Belgian post is entrusted with the provision of "Services of General Economic Interest" (SGEI) — public services that exceed the scope of the USOs. Some of those services directly pertain to the mail business, such as the maintenance of a large retail network, or the delivery of election mail and "freepost" letter post items.[37] The compensation payments received by bpost from the government in 2015 (about $305 million) represented a whopping 63 percent of its total Mail and Retail division profits.
- **Restructuring aids**. A couple of years before the 2013 privatization of Royal Mail, the U.K. government resolved to promote "a viable Royal Mail Group capable of attracting private sector investment to ensure its long term future." As part of this effort, it granted Royal Mail a restructuring aid in the form of a debt reduction of £1.1 billion ($1.4 billion) over the 2010-2015 period. The goal was to reduce the cost of Royal Mail's debt, generating the additional cash needed to restructure operations and restore profits. In fact, the aid was conditional on the implementation of a restructuring plan involving operational and IT modernization and a reduction in the number of sorting centers.

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33 At the time, an actuarial valuation showed a deficit of about £10 billion ($12.5 billion) in the pension plan covering employees who had joined before 2008. The deficit represented more than one-fourth of total liabilities. The Postal Services Act of 2011 enabled the U.K. government to take on this deficit by transferring pension assets and historic liabilities to a new fund. Department for Business Innovation & Skills, *2010 to 2015 government policy: postal service reform,* May 8, 2015, https://www.gov.uk/government/publications/2010-to-2015-government-policy-postal-service-reform/2010-to-2015-government-policy-postal-service-reform.

34 National Audit Office, *The Privatisation of Royal Mail*, Report No. HC 1182, April 1, 2014, https://www.nao.org.uk/wp-content/uploads/2014/04/The-privatisation-of-royal-mail.pdf, p. 16. However, responsibility for the benefits accrued after 2008 for employees who joined before that year remained with Royal Mail. In 2016, Royal Mail estimated that its pension fund would be underfunded beginning in 2018 and recommended a reduction of pension benefits. "Royal Mail moves to close defined-benefit pension fund," *Financial Times*, January 17, 2017, https://www.ft.com/content/d0e55e68-d35d-11e6-9341-7393bb2e1b51.

35 Australia Post Super Scheme, "Frequently Asked Questions," https://www.apss.com.au/Public/FAQ.html.

36 Australia Post's full monopoly on letter mail delivery and Swiss Post's monopoly on letters up to 50 grams are intended to ensure that these posts' revenue help cover the costs of their universal service obligations. A 2016 OIG white paper examined alternative funding methods for the universal service obligations. The paper presents international examples, for example Germany's universal compensation fund, provided for by the law but not put in place. OIG, *Funding the Universal Service Obligation*, Report No. RARC-WP-16-005, March 21, 2016, https://www.uspsoig.gov/sites/default/files/document-library-files/2016/RARC-WP-16-005.pdf.

37 "Freepost" refers to mail items delivered free of charge, such as mail between members of Parliament or government agencies.

- **Lower taxes**. In some cases, the government will offer tax cuts to all companies, not only postal operators. A case in point — although not from one of the five countries reviewed — is Groupe La Poste receiving about $350 million every year under a new tax credit program that promotes competitiveness and employment in France. In 2014, without the tax credit, its operating profits would have been down 42 percent compared to 2013.[38]

Cost Efficiencies Programs

In addition to analyzing strategies aimed at increasing mail revenues and reducing the workforce, we examined posts' strategies to achieve cost efficiencies. The following section describes these common strategies.

Reducing the Cost of the Retail Network

As posts' retail networks also act as a sales channel — for example, for stamps — and an acceptance channel for mail, lowering retail costs or raising retail revenues affects the profitability of mail. Some posts, like Australia and Belgium, combine the financial results of their mail and retail businesses into a single segment. To improve the financial performance of the retail network, posts have pursued two strategies separately or in tandem:

- **Generating additional revenue by offering more products at the retail outlets.** Three of the five posts pursued this strategy:
  - Swiss Post sells office supplies, concert tickets, and mobile subscriptions.[39]
  - Australia Post offers identity services, insurance and payment services, and travel services across its retail network.[40]
  - In Belgium, in addition to receiving financial compensation for its wide network, bpost offers other services at its retail outlets, including banking.[41]
- **Reducing the cost of operating the network**. Three of the five posts have done it by outsourcing or franchising their retail presence:
  - Eighty-three percent of Australia Post's retail network is outsourced to privately-owned Licensed Post Offices and, in rural areas, Community Postal Agents. Only 17 percent of retail outlets are Australia Post-owned and managed.[42]
  - Deutsche Post completed the transfer to external partners of all but two post offices by the end of 2010.[43] The two remaining post-owned offices are at headquarters and in the German Parliament.
  - In the United Kingdom, Post Office Ltd. was from 1986 to 2012 the retail network subsidiary of the post. In 2012, shortly before the privatization of Royal Mail, it became a separate, government-owned company.[44]

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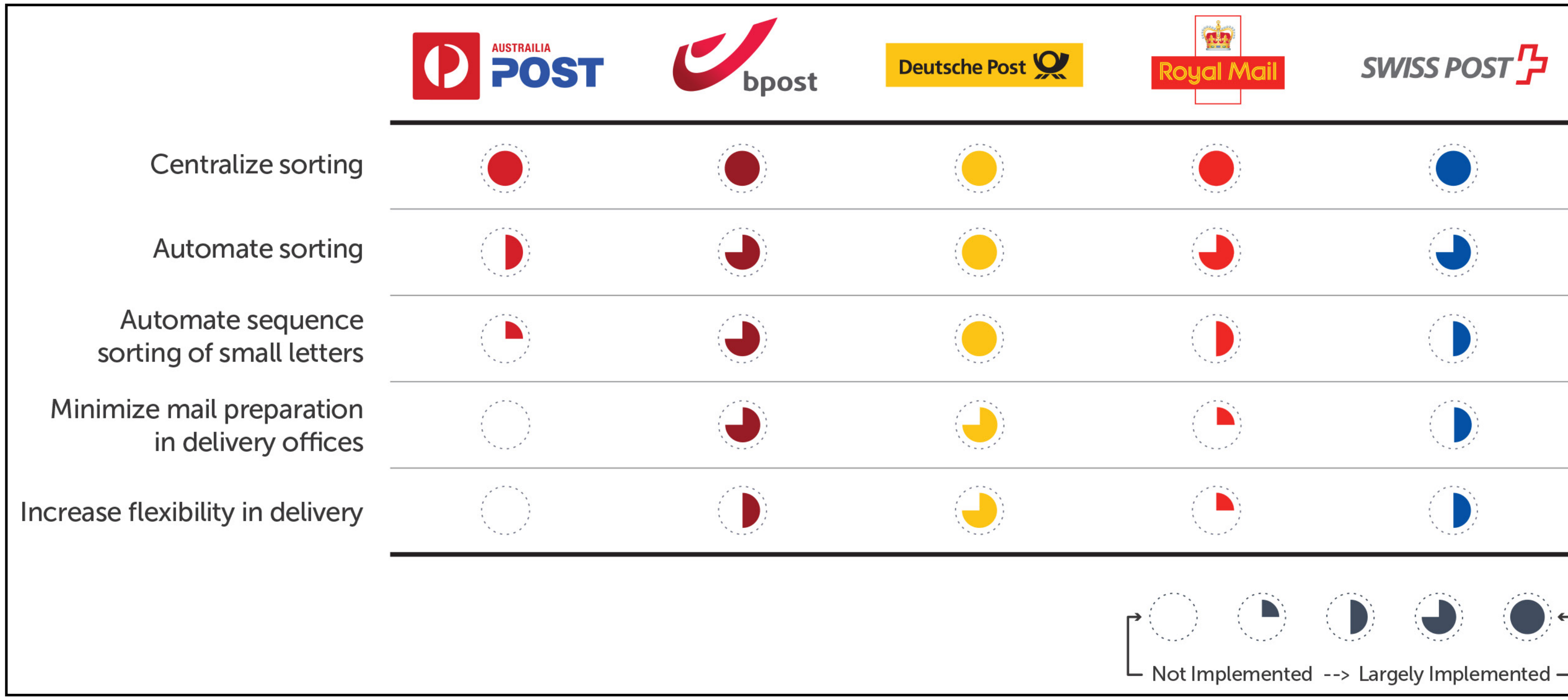
38 Under the program, all companies in France benefit from a tax credit amounting to 6 percent of salaries paid. "La Poste Group profits hit by declining mail volumes," *Postandparcel*, February 21, 2014, http://postandparcel.info/60177/news/companies/la-poste-group-profits-hit-by-declining-mail-volumes/. Cour des Comptes — the French GAO — has recently analyzed the financial impact of this tax cut on Groupe La Poste's profits from 2013 to 2020. Cour des Comptes, *La Poste, une transformation à accélérer*, Public Report, December 2016, https://www.ccomptes.fr/Actualites/A-la-une/La-Poste-une-transformation-a-accelerer, pp. 37-39.
39 Swiss Post web site, https://www.post.ch/en/private/privat-shopping/post-office-shopping.
40 The McKell Institute, *Digital Post: Business transformation and the future sustainability of Australia Post*, April 2015, p. 99.
41 Bpost, *With Confidence: Bpost Annual Report 2015*, http://corporate.bpost.be/~/media/Files/B/Bpost/annual-reports/bpost%20annual%20report%202015_EN.pdf, p.38.
42 The McKell Institute, *Digital Post: Business transformation and the future sustainability of Australia Post*, April 2015, p. 45.
43 OIG, *Lessons in Price Regulation from International Posts*, Appendix A, p.35.
44 Post Office Ltd still has a contractual agreement with Royal Mail whereby it accepts letters and parcels (and postage payments) on behalf of Royal Mail, and provides parcels pickup at its outlets and warehousing. In 2015/2016, these services represented only 34 percent of Post Office Ltd revenue, compared to 44 percent for financial and government services, and 22 percent for other retail services. In spite of a high degree of diversification, the company was barely profitable. Post Office Limited, *Annual Report and Financial Statements 2015/16*, 2016, http://corporate.postoffice.co.uk/sites/default/files/AnnualReport1516.pdf, pp.11-12.

Looking to the future, Swiss Post plans to reduce the number of traditional post offices by 2020, replacing them with postal agencies (for example, postal counters in shops) and postal terminals.[45] This should help it protect mail profits over the next few years.[46]

Sorting and Delivery: Similar Strategies, Different Timings

Posts have been able to further reduce operational expenses by promoting efficiency throughout their network. They have largely done this by streamlining and rationalizing their mail processing and delivery networks. The different types of network efficiency measures, as well as each post's progress toward implementation, are summarized in Figure 8 below.

Figure 8: Level of Implementation of Cost Efficiency Programs



Source: WIK.

Consolidation and centralization of mail processing and sorting facilities has been a common, and successful, strategy. For example, in 2003, Swiss Post launched their Reengineering Mail Processing (REMA) program, which reduced sorting facilities by half. Royal Mail saw similar results from the transformation program it began in 2008, which reduced the number of sorting centers from 69 to 39. Posts often combine this consolidation with increased automation of sequence sorting. Royal Mail increased its sequence sort rates from 34 percent in 2010 to 82 percent by 2015.[47]

45 Swiss Post plans to reduce the number of post-owned post offices from 1,400 to as few as 800. "Swiss Post unveils 'network of the future,'" *Postandparcel*, October 26, 2016, http://postandparcel.info/76245/news/swiss-post-unveils-network-of-the-future/.
46 For the moment, mail partly subsidizes the loss-making retail division. In accordance with Swiss law, the post transferred $128 million from its mail and parcels divisions in 2015 to compensate for the net costs of universal service provision incurred by the retail division. PostCom, *Annual Report 2015*, http://www.postcom.admin.ch/fr/publikationen/PostCom_Jahresbericht_2015_FR.pdf, p. 25 and Swiss Post, *Financial Report 2015*, p. 60.
47 Australia Post has also seen some early success, achieving a 50 percent sequence sort rate for small letters in 2014.

Optimizing not just the sorting but the delivery of letters can also lead to much-needed savings. Over 20 years ago, Deutsche Post DHL started decreasing the number of its delivery offices from 11,000 to 3,700.[48] At bpost, delivery efficiency initiatives extend not only to delivery sequence sorting but also to mailbag preparation. As a result, there is no longer mail preparation in post offices.

As Figure 8 shows, posts have largely tried the same five initiatives of increasing efficiency.[49] However, their progress to this point is largely dependent on the date of implementation. Deutsche Post began boosting operational efficiencies in the early 1990s (Box 2). Likewise, bpost and Swiss Post started early and have mostly completed their major efficiency programs. These three posts have thus already realized cost savings from these initiatives, which translated into higher profitability. Australia Post and Royal Mail, on the other hand, started much later. They have not yet realized the full effects of their efforts, so they will likely see greater cost savings in the coming years.

Box 2: Excellence in Efficiency Gains — Deutsche Post DHL

Starting as far back as 1990, Deutsche Post DHL began to centralize and automate its sorting activities for both letters and parcels. Through these efforts they replaced 328 letter sorting centers with 83 highly-automated sorting centers, consolidated parcel sorting, introduced the sorting of letter mail to delivery sequence, and reduced transportation costs. The post was also early to consolidate delivery facilities as well as drive costs out of their retail network by switching from post-owned post offices to postal agencies.

These early efforts helped establish a solid baseline for Deutsche Post DHL, but it continues to invest money in automation and sequencing. It recently spent over €400 million ($423 million) to install sorting machines that can sort flats to delivery sequence, use less energy, and sort 40,000 items per hour (compared to the 13,000 items per hour the previous machines could sort). The projected savings derived from these machines exceeds €100 million ($106 million) per year.

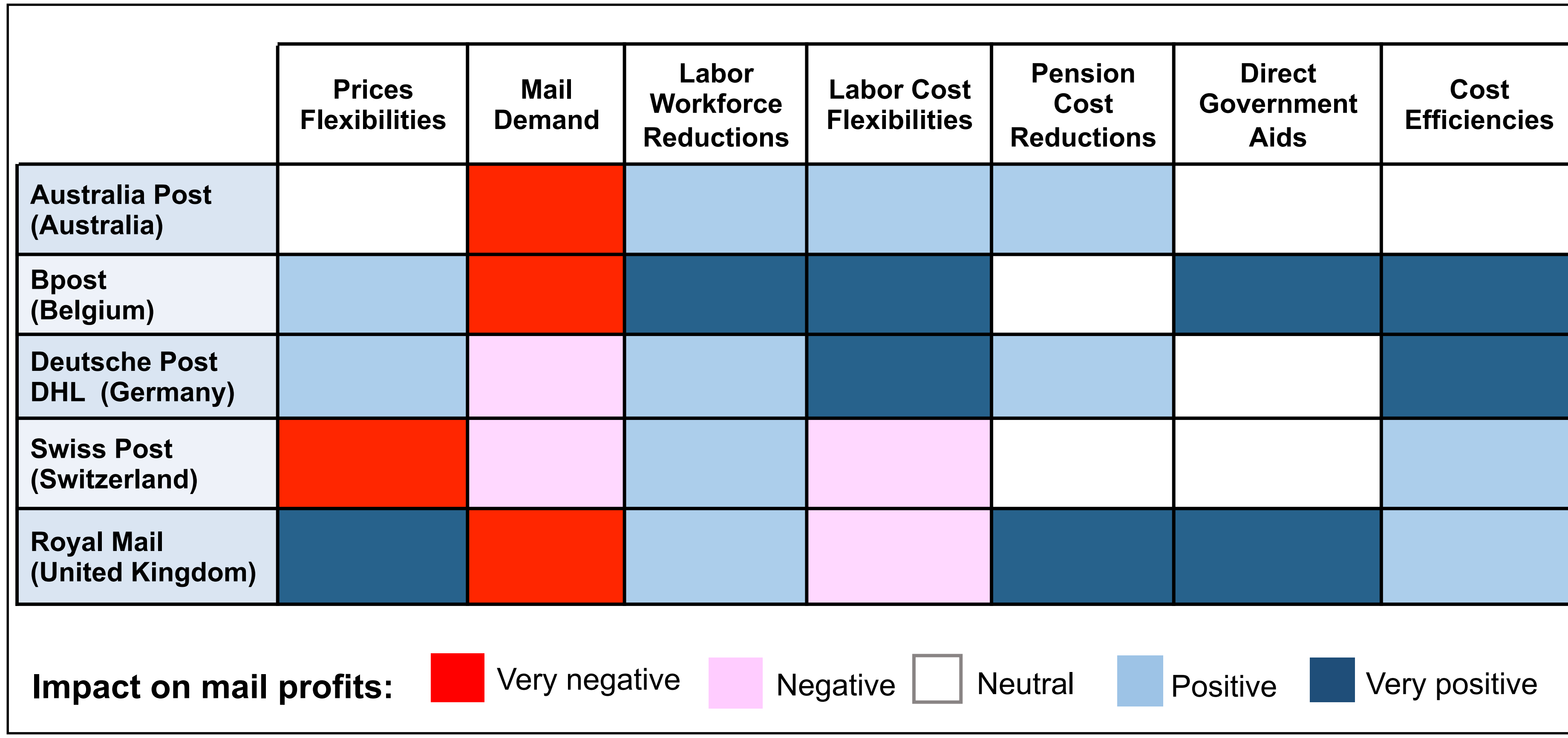
Conclusion

Though they operate in different legal and market environments, most international posts have succeeded in keeping their letter mail business profitable and strategically relevant. In a majority of the posts surveyed, mail remains the largest source of profits.

On the revenue side, price increases have compensated in part for volume decreases. In a few countries, resilient mail demand has helped keep mail profitable. On the cost side, posts have used similar cost reduction strategies, such as automated sorting, consolidating the network, and reducing labor costs. These levers have played out differently depending on the country. Figure 9 summarizes the different impacts that the main drivers of mail profitability had on posts' profit margins in the 2011-2015 period.

48 The delivery office is the delivery unit where the letter carrier leaves from to begin her route. It can be in the same building as a postal retail unit, as is often the case in the United States, or a stand-alone facility.
49 In some cases, posts had multiple phases of cost efficiency programs.

Figure 9: The Main Drivers of Mail Profitability and Their Impact on Posts' Profit Margins 2011-2015.



Source: OIG analysis.

In practice, the level of the mail profit margin directly depends on two intertwined factors. First is the level of government support, which can be manifested through a legal and regulatory environment that gives posts the same freedoms as other businesses, or through various financial aids. Second is the date at which changes were implemented. The earlier the restructuring efforts began — often in the lead-up to privatization — and the better the quality of execution, the higher the impact on posts' mail profitability.

In spite of a declining demand for mail, over the past 5 years most posts have maintained, even increased, their mail EBIT margin. Mail should remain, for the foreseeable future, a key component of their product portfolios and profitability.

Appendices

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Appendix B: Management's Comments

JOSEPH CORBETT
CHIEF FINANCIAL OFFICER
EXECUTIVE VICE PRESIDENT

UNITED STATES POSTAL SERVICE

April 19, 2017

CHRISTOPHER BACKLEY
ACTING DIRECTOR, RARC CENTRAL
RISK ANALYSIS RESEARCH CENTER

SUBJECT: USPS Response to Mail Profitability in International Posts White Paper (Project Number 2016RARC015)

We read your report, Mail Profitability in International Posts, with great interest. Your findings on the financial performance, operations, and regulatory constraints of selected foreign posts align with our understanding of the issues that other posts have faced regarding their domestic mail.

Thank you.

Joseph Corbett

cc: Paola Piscioneri
Sally Haring
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