

# Section 701 Report

Analysis of the Postal Accountability and Enhancement Act of 2006



Postal Regulatory Commission

September 22, 2011

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## Table of Contents

	<i>Page</i>
CHAPTER I: Executive Summary .....	1
CHAPTER II: Legal Background .....	4
CHAPTER III: Procedural History.....	5
CHAPTER IV: Operation of the PAEA Amendments and Recommendations for Legislative Improvements.....	7
A. Overview of The Postal Regulatory Commission’s Statutory Roles.....	7
1. The Regulatory Environment Under the PAEA .....	7
2. Implementation of the Commission’s Responsibilities Under the PAEA .....	9
3. Commission Experience with Certain Aspects of Postal Regulation Under the PAEA.....	10
B. Financial and Transparency Issues .....	13
1. Retirement Funds.....	13
2. Sarbanes-Oxley Act Compliance .....	25
C. Rate and Service Matters .....	28
1. Market Dominant Price Cap .....	28
2. Market Dominant Classes of Mail.....	41
3. Nonpostal Services .....	44
4. NSAs and Special Classifications .....	51
5. Service Performance Measurements and Customer Satisfaction .....	56
6. Market Tests of Experimental Products .....	65
D. Enhancements to Improve the Commission’s Processes .....	71
1. Post Office Closing Procedures .....	71
2. Advisory Opinion Process .....	78
CHAPTER V: Conclusion .....	86
Attachment—Comments of the United States Postal Service	
Appendix—Comments of the United States Department of State	

701 Report

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## CHAPTER I: EXECUTIVE SUMMARY

This marks the Postal Regulatory Commission's (Commission) first report under section 701 of the Postal Accountability and Enhancement Act (PAEA) of 2006. That section directs the Commission to submit a report to the President and Congress, at least every five years, regarding how well the PAEA is operating and to recommend measures to improve the effectiveness and efficiency of postal laws.

The Commission recognizes the difficult environment that the Postal Service faces in 2011 and how it is starkly different from the environment that existed in 2006. At the time of the passage of the PAEA, the Postal Service's volume was growing and it was earning revenues that exceeded costs. However, the postal sector and the financial condition of the Postal Service have dramatically changed since the passage of the PAEA.

This report does not propose sweeping structural changes to the Postal Service or its universal service obligation. Instead, in fulfillment of its responsibilities under PAEA section 701, the Commission makes recommendations for improvements to postal laws within the framework of the PAEA (701 Report). These recommendations will enhance the Postal Service's flexibility, and help it to meet the challenges of today's difficult financial environment.

The report focuses on three main areas that the Commission has been closely involved with in the implementation of the PAEA.

- 1) The report addresses the financial situation of the Postal Service with recommendations on retirement funding and discusses transparency issues with regard to Postal Service annual reporting, including Sarbanes-Oxley Act compliance.
- 2) The report discusses rate and service matters, including the price cap, market dominant classes of mail, nonpostal services, negotiated service agreements and special classifications, service performance measurement, and market tests.

- 3) The report addresses enhancements to improve the Commission's processes, including post office closing procedures and the advisory opinion process.

With respect to financial and transparency issues, the Commission makes the following key recommendation:

- The Commission recommends that Congress adjust the current Postal Service Retiree Health Benefit Fund (PSRHBF) payment schedule. To assist in determining how to make an appropriate adjustment, the Commission provides actuarially sound alternative payment options for Congress to consider in keeping with the spirit of the law while adjusting the scheduled annual prefunding payments in recognition of the current liquidity challenges facing the Postal Service. The Commission also recommends that Congress consider the PAEA section 802(c) report on the Postal Service's Civil Service Retirement System liability as a potential remedy for the PSRHBF issues.

With respect to rate and service matters, the Commission makes the following key recommendations:

- The Commission recommends that the PAEA be enhanced by explicitly allowing the Postal Service to add new market dominant classes of mail. This legislative enhancement will allow the Postal Service to adapt to the rapidly changing needs of mail users and the postal system.
- If Congress decides to allow the Postal Service to offer new nonpostal services, those services should have appropriate regulatory oversight and review. Proper regulatory review and oversight will ensure that the Postal Service offers profitable, new nonpostal services and does not disrupt the competitive marketplace.
- The Commission recommends that Congress consider amending the statute by raising the maximum revenue limitation on market tests of experimental products to encourage innovation on a larger scale.
- Congress should consider clarifying the law to ensure that consultations with the Commission are required for changes to service standards.
- While the Commission has not vetted this concept, Congress should consider providing an opportunity for the Postal Service to achieve increased pricing authority by increasing quality of service. This will provide the Postal Service with a financial incentive to improve service and increase revenues.

With respect to enhancements to improve the Commission's processes, the Commission makes the following key recommendations:

- The Commission recommends that Congress consider requiring the Postal Service to provide regular reports to the Commission on its retail network plans and activities. In recognition of the Postal Service's current plans to realign its retail network, regular reporting on the Postal Service's retail network's closure and consolidation efforts to Congress, the public, and the Commission will further the PAEA goals of transparency and accountability.
- The Commission recommends that the scope of appellate review from Postal Service determinations to close Postal Service operated retail facilities be clarified and adopt the plain meaning of post office to include all retail offices operated by the Postal Service.
- The Commission recommends that Congress consider adding statutory language that would allow the Postal Service to obtain expedited consideration for time sensitive requests for advisory opinions on proposals to change service on a nationwide or substantially nationwide basis. Additionally, Congress should consider adding language to 39 U.S.C. 3661 requiring the Postal Service to provide a written response to Commission advisory opinions and submit its response to Congress prior to implementing such changes in service.

## CHAPTER II: LEGAL BACKGROUND

Under the PAEA, Pub. L. 109-435, 120 Stat. 3198 (2006), section 701, the Postal Regulatory Commission is required to

(a) [S]ubmit a report to the President and Congress concerning— (1) the operation of the amendments made by this Act [PAEA]; and (2) recommendations for any legislation or other measures necessary to improve the effectiveness or efficiency of the postal laws of the United States.

(b) Postal Service Views.—A report under this section shall be submitted only after reasonable opportunity has been afforded to the Postal Service to review the report and to submit written comments on the report. Any comments timely received from the Postal Service under the preceding sentence shall be attached to the report....

The Commission is required to present its “701 Report” to the President and Congress at least every five years from the date of the enactment of the PAEA. In presenting its 701 Report to the President and Congress, PAEA section 701(b) requires the Commission to afford the Postal Service a reasonable opportunity to review the report and submit written comments. PAEA section 701(b). The Postal Service’s comments are required to be attached to the Commission’s 701 Report. *Id.*

This report marks the Commission’s first 701 Report to the President and Congress. Over the past five years, the Commission has gained a wealth of experience implementing the provisions of the PAEA. This 701 Report reviews, as appropriate, the operation of the PAEA’s amendments to the United States Code and makes recommendations for any legislation or other measures to enhance the effectiveness and efficiency of the postal laws of the United States for the President and Congress to consider.

### CHAPTER III: PROCEDURAL HISTORY

In PAEA section 701, Congress sought the Commission's views on the operation of the PAEA and recommendations for legislative action. To assure that the public's ideas are taken into consideration, on December 3, 2010, the Postal Regulatory Commission announced that it was soliciting comments from interested persons to aid in the development of the 701 Report.<sup>1</sup> In its announcement, the Commission stated that in order to assist the Commission's views as it conducts its review in preparation for issuing this 701 Report, it would hold an informal public forum and allow interested parties an opportunity to submit informal written comments. The Commission also posted this information on its website and stated that the informal deadline for comments was February 1, 2011. The Commission has reviewed all comments submitted including those received after February 1, 2011.

The Commission held a public forum on January 11, 2011, in the Commission's hearing room. Forty-seven members of the public attended the forum. The forum was also webcast and garnered 89 listeners. In addition to the forum, 26 timely comments were received by U.S. Mail and e-mail.<sup>2</sup> The Commission has reviewed the comments submitted and the suggestions made at the public forum to be better informed on the concerns of mailers and the public.

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<sup>1</sup> See Postal Regulatory Commission Press Release *PRC Seeks Input on Improving Postal Laws of the United States*, December 3, 2010.

<sup>2</sup> The United States Department of State was the only Federal agency to submit comments. Its comments were submitted on July 6, 2011, after this report was largely completed. As a result, the Commission was unable to fully consider its proposals. As a matter of inter-agency comity, the Commission is attaching the Department of State's comments, in its entirety, to this report for the President and Congress's consideration. See Appendix.

In accordance with PAEA section 701(b), the Commission submitted a copy of the report to the Postal Service on August 5, 2011, and it requested comments by August 26, 2011. The Postal Service's comments were received on September 16, 2011. See Attachment.

## CHAPTER IV: OPERATION OF THE PAEA AMENDMENTS AND RECOMMENDATIONS FOR LEGISLATIVE IMPROVEMENTS

### A. Overview of The Postal Regulatory Commission's Statutory Roles

#### 1. The Regulatory Environment Under the PAEA

The PAEA significantly altered and modernized postal law with respect to rate regulation and service standards, increased transparency and accountability, enhanced the authority and responsibilities of the newly reconstituted Postal Regulatory Commission (Commission),<sup>3</sup> and required a variety of evaluations and reports including an annual determination of the Postal Service's compliance with applicable laws, known as the Annual Compliance Determination. It ended the previously mandated break-even financial model and encouraged the Postal Service to reinvest retained earnings. The PAEA also abolished the Postal Service's previous authority to provide nonpostal service offerings with the exception of certain "grandfathered" nonpostal services.

The law provided the Postal Service with increased pricing flexibility and separated postal products and services into two discrete categories, market dominant and competitive. The market dominant category includes products for which the Postal Service has a monopoly or would be able to exercise substantial market power. For market dominant products, the law provides the Postal Service with flexibility to price those products as it deems appropriate, subject to a price cap for each class of mail equal to the annual Consumer Price Index (CPI). The competitive category includes all other postal products.

The Postal Service has complete flexibility in pricing each of these products as long as each such competitive product covers its costs. Additionally, competitive products as a whole must not be subsidized by market dominant products, and must

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<sup>3</sup> The Postal Regulatory Commission is the successor agency of the Postal Rate Commission.

make an appropriate contribution to institutional costs as determined by the Commission. The Postal Service also gained additional flexibility to test new experimental postal products as well as enter into international contracts, individual contracts, and other negotiated service agreements with mailers.

The PAEA creates three main requirements for service standards. First, the Postal Service, in consultation with the Commission, is required to establish a set of service standards for market dominant products that reflect current network capabilities. Second, objective measurement systems are to be established and implemented with the approval of the Commission. Third, the Postal Service, in consultation with the Commission, is required to submit a plan to Congress that includes the Postal Service's vision for rationalizing the network to improve efficiency and meet the new service standard goals.

The PAEA requires separate accounting for the groupings of products within the market dominant and competitive categories. A new Competitive Products Fund, apart from the existing Postal Service Fund, was established at the U.S. Department of Treasury. An assumed income tax is applied to profits from the Competitive Products Fund and transferred to the Postal Service Fund to help defray costs for meeting the universal service obligation.

Another aspect of the PAEA entails funding for Postal Service retiree health benefits. It requires the Postal Service to begin funding the Postal Service portion of future retiree health benefits. For a 10-year period, the Postal Service is required to pay each year between \$5.4 billion and \$5.8 billion into a newly created PSRHBFB.

Under the PAEA, the Postal Regulatory Commission's role changed significantly from that of the Postal Rate Commission. The law directed the Commission to establish a modern ratemaking process and to conduct a formal compliance review of Postal Service prices and services on an annual basis.

The law also significantly increased the scope and remedies available to parties filing rate or service complaints with the Commission. Additionally, the law established schedules for the Commission to report to the President and Congress on a number of postal policy issues such as on the universal service obligation and monopoly status of the Postal Service. The PAEA generally provided for a less adversarial and more expeditious rate setting process that typically takes less than two months. Moreover, the PAEA strengthened the Commission's oversight authority by providing it with subpoena power over officers, employees, agents, and contractors of the Postal Service. Finally, the law required the Postal Service to submit certain Sarbanes-Oxley Reports to the Commission.

## 2. Implementation of the Commission's Responsibilities Under the PAEA

The Postal Regulatory Commission acted promptly to put into operation the new key provisions of the law that it was tasked with implementing. In October 2007, the Commission issued new rules overhauling the previous cost-of-service ratemaking regulations and setting forth the modern system of ratemaking framework as required by the PAEA—eight months ahead of the statutory schedule. See 39 U.S.C. 3622. The Commission, in April 2009, issued periodic reporting rules as required by the PAEA. See 39 U.S.C. 3651-53. These rules fulfill the goal of increased transparency and accountability of the Postal Service and identify the information production necessary to prepare the PAEA's mandated Annual Compliance Determination and other periodic reports. These rules balance the burden of information with the necessity to fulfill the Commission's statutory mandate and the mailing public's right to transparency.

The Commission implemented the PAEA's enhanced oversight requirements by publishing final rules for complaints and confidentiality in FY 2009. 39 U.S.C. 3662, 504(g). The Commission also issued its rules for accounting practices and tax treatment related to Postal Service competitive products in FY 2009. 39 U.S.C. 2011. These accounting and tax treatment rules ensure that proper accounting procedures are

used by the Postal Service and that the Postal Service does not engage in unfair competition with respect to its competitive products. The Commission also issued the PAEA mandated report to Congress on universal postal service and the postal monopoly in the United States in FY 2009, including the monopoly on mail delivery and access to mailboxes. PAEA section 702. In FY 2010, the Commission issued final rules for procedures on obtaining information from the Postal Service, including the use of subpoenas. 39 U.S.C. 504(f). All of these Commission rules and reports were prepared with the benefit of public comments.

### 3. Commission Experience with Certain Aspects of Postal Regulation Under the PAEA

The Postal Service is granted wide flexibility in setting prices for both market dominant and competitive products as a result of the PAEA. However, as discussed below, that flexibility has not always been exercised. To ensure compliance with the law, the Commission instructed the Postal Service to make adjustments to the Postal Service's proposed market dominant rates twice in the past five years. New procedures and regulations made possible by the PAEA have streamlined the Commission's review processes. Since the passage of the PAEA through November 2010, the Commission has reviewed 238 competitive NSAs and 4 market dominant NSAs.

The PAEA also provided the Postal Service with significant flexibility in the classification of its products. Since the passage of the PAEA through May 2011, the Commission has reviewed 117 requests to make changes to the Mail Classification Schedule, including the creation of new products, 6 experimental market test products, 16 requests for market dominant rate changes, including innovative pricing strategies such as "summer sales," 9 requests for competitive rate changes of general applicability, and 1 request for an exigent rate increase. In addition, the Commission has reviewed four requests to transfer products from the market dominant product list to the competitive product list. See, e.g., Docket No. MC2010-36: Transferring Commercial Standard Mail Parcels to the Competitive Product List.

The Commission's Annual Compliance Determination (ACD) and other periodic reports ensure that the Postal Service is following applicable legal requirements and that there is an appropriate level of transparency and accountability to the public. Since the passage of the PAEA, the Commission has issued four ACDs. During that time, the rates for one product, Standard Mail Flats, were found to be out of compliance with applicable statutory requirements.<sup>4</sup> Prior to finding the Postal Service out of compliance with respect to Standard Mail flats, in previous ACDs and in other ways, the Commission repeatedly encouraged the Postal Service to use the flexibility given by the PAEA to reduce costs or change the pricing structure for flats without the need for Commission intervention.

The Commission has considered two major mailer complaints since Congress passed the PAEA. The first complaint, brought by Capital One Services, Inc. (Capital One), concerned allegations that the Postal Service was allowing unfair competition to occur since it was not providing Capital One with a negotiated service agreement similar to that provided to Bank of America Corporation. This case was ultimately settled by Capital One and the Postal Service without the need for a Commission decision on the merits.

The second complaint, brought by GameFly, Inc., concerned allegations of unlawful discrimination. Specifically, GameFly, Inc. alleged unfair discrimination between letter and flats mailers who rent DVDs sent through the mail. The Commission issued its decision finding in favor of GameFly, Inc. on April 20, 2011, and directed the Postal Service to modify its Mail Classification Schedule for round-trip DVD mail.<sup>5</sup>

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<sup>4</sup> Section 3653(c) of title 39 states that the Commission shall take appropriate action in accordance with subsections (c) and (e) of section 3662 if the Commission makes a determination of noncompliance. The reference to subsection (e) should be to subsection (d). The Commission recommends that Congress make this technical correction.

<sup>5</sup> See Docket No. C2009-1, Order No. 718, Order on Complaint, April 20, 2011 (Order No. 718).

The PAEA granted the Commission subpoena authority. To date, the Commission has not found it necessary to issue any subpoenas, and encourages the Postal Service to continue providing the necessary information to ensure the transparency and accountability of the postal system.

Most key provisions of the PAEA, as implemented by the Postal Service and the Commission, are functioning properly. An important aspect of the PAEA is the requirement for periodic reports to identify needed modification to the statutory structure. In this report, the Commission offers recommendations for legislative change with respect to retirement funds for postal employees, Sarbanes-Oxley Act compliance, market dominant price caps, market dominant classes of mail, nonpostal services, negotiated service agreements, service standards, market tests, post office closing procedures, and the advisory opinion process.

## B. Financial and Transparency Issues

### 1. Retirement Funds

#### a. Introduction and Summary

The PAEA significantly altered the manner in which the Postal Service funds its retiree health benefits, including the financing requirements for employee benefits. Prior to the PAEA, the Postal Service, like other Federal agencies, was required to pay the employer's share of health insurance premiums for all current postal retirees and their survivors who participate in the Federal Employee Health Benefits Program (FEHBP) on a pay-as-you-go basis. The PAEA requires the Postal Service to continue to make the "pay-as-you-go" premium payments, but further requires the Postal Service to make additional scheduled annual payments to prefund premiums for future retirees, which are paid into a newly created PSRHBFB overseen by the Office of Personnel Management (OPM).

The Commission has found that the principal cause of the Postal Service's current financial challenges is the current prefunding schedule.<sup>6</sup> The Commission, therefore, provides alternative payment options for Congress to consider in keeping with the spirit of the law while adjusting the scheduled annual prefunding payments in recognition of the severe current liquidity challenges facing the Postal Service.

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<sup>6</sup> See Commission Docket No. R2010-4, Order Denying Request for Exigent Rate Adjustments, September 30, 2010, at 68-80 (Order No. 547).

b. Pre-PAEA Funding of Retiree Health Benefit Premiums and Pension Benefits

(1) Retiree Health Benefit Premiums

Pub. L. 99-272 and the Omnibus Budget Reconciliation Act of 1990 require the Postal Service to pay the employer's share of health insurance premiums for all current postal retirees and their survivors who retire on or after July 1, 1971, and who participate in the FEHBP. The costs for the premiums are prorated for creditable civilian service prior to July 1, 1971, with the Federal government paying the portion of the premiums related to service prior to that date. These "pay-as-you-go" premium payments were the only premium payments required to be paid by the Postal Service for its retirees until the passage of the PAEA.

(2) Civil Service Retirement System Pension Benefit Obligation

The Postal Service's obligation to the Civil Service Retirement System (CSRS) has been altered by several different pieces of legislation.

*Pub. L. 93-349.* Enacted on July 12, 1974, Pub. L. 93-349 required the Postal Service to assume the increase in the liability of the CSRS due to increases in pay granted by the Postal Service since July 1, 1971. The liability increase was to be determined by OPM and to be paid by the Postal Service over 30 equal annual installments with interest computed at the rate used in the most recent valuation of the CSRS. Beginning on June 30, 1975, the Postal Service began making payments to the

CSRS for the estimated increased liability. These payments continued until FY 2003, when Pub. L. 108-18 changed the Postal Service's funding requirements for CSRS.<sup>7</sup>

*Pub. L. 108-18.* The Postal Civil Service Retirement System Funding Reform Act of 2003, Pub. L. 108-18, changed the way the Postal Service's CSRS retirement liability was calculated and funded. At the request of Congress, OPM conducted a review of the Postal Service's CSRS liability and the scheduled funding and found that at the current rate of funding, the Postal Service would pay substantially more than would be required to fully fund future pension benefits of Postal Service employees participating in the CSRS. In response to the apparent overfunding of the CSRS pension liability, Pub. L. 108-18 changed the funding methodology for the Postal Service's share of the CSRS.

There were two primary changes to the Postal Service's method of funding the CSRS as a result of Pub. L. 108-18. First, military service time CSRS pension obligations that had been credited to Postal Service employees and had been paid for by the Federal government was made the responsibility of the Postal Service. Additionally, the employer's share of the payment to the CSRS Fund was changed from a static 7 percent of an employee's basic salary to an actuarially determined amount known as "dynamic funding."

Additionally, Pub. L. 108-18 instructed OPM to reevaluate the CSRS Fund each year as it relates to Postal Service employees. If OPM calculates a supplemental Postal Service liability, the Postal Service would be required to make supplemental payments sufficient to fully fund the amount within 40 years.

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<sup>7</sup> Several Omnibus Budget Reconciliation Acts of the late 1980s and early 1990s made the Postal Service liable for the cost of Cost of Living Adjustments (COLAs) granted to most Postal Service annuitants. These acts also required the Postal Service to pay the employer's share of the FEHBP for all postal annuitants and their survivors. For a complete discussion of these statutory changes, see the Postal Regulatory Commission's Review of Retiree Health Benefit Fund Liability as Calculated by Office of Personnel Management and U. S. Postal Service Office of Inspector General, July 30, 2009.

The final major change of Pub. L. 108-18 was that the Postal Service's savings from the changes to its CSRS funding requirements would be used to reduce its accumulated long-term debt and to delay rate increases from 2003 to 2005. Any estimated savings after FY 2005 were placed in escrow until Congress determined a use for the estimated savings.

c. Funding of CSRS and Retiree Health Benefit Premiums  
Under the PAEA

(1) Funding of the PSRHBF

The PAEA established the PSRHBF and initially funded it with the FY 2006 escrow transfer in the amount of \$3 billion and an OPM-determined FY 2006 Postal Service surplus from the CSRS Fund in the amount of \$17 billion.

The PAEA requires the Postal Service to pay annual statutory installments of an average of \$5.6 billion into the PSRHBF over 10 years from FY 2007 through FY 2016.<sup>8</sup>

Beginning in FY 2017, the PAEA requires OPM to evaluate the PSRHBF every year and actuarially determine the overall liabilities for retiree health benefits for current employees, annuitants and survivors, the value of assets, and the fund balance. At that time, the Postal Service will be required to pay the actuarially determined cost for retiree health benefits for current employees into the PSRHBF while the annual "pay-as-you-go" premiums for the Postal Service's annuitants and survivors will be paid out of the PSRHBF.

OPM annually determines the PSRHBF fund balance and, in the case of an unfunded liability, establishes a schedule of annual payments for the liquidation of such

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<sup>8</sup> Pub. L. 109-135 altered the payment schedule for FY 2009, reducing the scheduled annual payment for that year from \$5.4 billion to \$1.4 billion.

liability. The Postal Service will then make annual amortization payments into the fund to liquidate the unfunded liability by FY 2056.

(2) Funding of the Postal Service Portion of the CSRS

The PAEA also significantly changed much of the funding requirements for the CSRS. It removed the requirement for actuarially determining the funding for the Postal Service's portion of the CSRS, and it also transferred the military service time for postal employees back to the responsibility of the Federal government. OPM was also required to evaluate the CSRS pension liability each year by June 30. If a surplus exists, the surplus is to be transferred to the newly created PSRHBF. Transfers of any CSRS surplus to the PSRHBF will occur at the close of FY 2015, 2025, 2035 and 2039. If there is an unfunded liability, the Postal Service is to pay the present value equivalent of the unfunded liability over a 40-year term with interest into the fund.

d. Commission Experience with the Retirement Funds

(1) Commission Study on the PSRHBF

At the request of Congress, the Commission undertook an analysis of the different approaches employed by the U.S. Postal Service Office of Inspector General (OIG) and OPM to calculate the present value of the Postal Service's obligations related to the PSRHBF.<sup>9</sup>

The Commission's July 30, 2009 report found that the two valuations were developed for different reasons and both were reasonable. The OPM estimate serves to meet an annual financial reporting requirement. In contrast, the OIG estimate is designed to determine the funded status of the PSRHBF as of year 2016.

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<sup>9</sup> The analysis was requested by the Subcommittee on Federal Workforce, the Postal Service, and the District of Columbia, Committee on Oversight and Government Reform, U.S. House of Representatives.

In the Commission's analysis, it recommended that OPM make changes to its valuation methodology. Specifically, the Commission found that a graded trend rate is preferable because such a methodology reflects current expectations of health care inflation and the percentage of the national Gross Domestic Product that will be consumed by health care costs in the future. Additionally, the Commission's report noted that OPM was not taking into account the current rate of decline in Postal Service employee levels and recommended that OPM reflect these declining workforce estimates in its valuation methodologies.

The use of the graded inflation assumption and the declining workforce assumption is expected to result in a lower liability for retiree health benefits in the future as shown in the table below.<sup>10</sup>

Table 1

PSRHBF Estimated Payments as of 2009 to Maintain Same Funding Level Under Different Assumptions (Dollars in Billions)			
	USPS OIG	OPM	PRC Alternative
Workforce	Declining	Fixed	Declining
Health Care Inflation	5%	7%	8% – 5%
Interest Earnings	5.35%	6.25%	5.35%
Discount Rate on Liability	6.25 %	6.25%	6.25%
<b>FY 2016 Estimated Liabilities</b>	<b>90.50</b>	<b>147.91</b>	<b>113.20</b>
FY 2016 Estimated Assets	103.70	108.71	103.70
FY 2016 Estimated Unfunded Liability	(13.20)	39.20	9.50
2016 Estimated Asset Balance (73% funding)	66.07	107.97	82.64
<b>Fixed Annual Payment</b>	<b>\$1.7</b>	<b>\$5.5</b>	<b>\$3.4</b>

OPM changed its medical inflation assumption to one in line with the Commission's recommendation in its calculation of the PSRHBF liability for FY 2009.

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<sup>10</sup> Using OPM's current valuation and the scheduled payments into the fund required by the PAEA results in a funded status of 73 percent in 2016.

## (2) Commission Study on the CSRS

The PAEA section 802(c) contains a provision allowing the Postal Service to request that the Commission hire an actuary to perform an independent review of current allocations of the CSRS costs. The OIG issued a report on January 20, 2010 questioning the appropriateness of the current allocations of CSRS costs.<sup>11</sup> In light of that report, the Postal Service exercised its right of Commission review under the PAEA section 802(c). The Commission hired The Segal Company (Segal) to perform the PAEA section 802(c) independent review.

On June 30, 2010, the Commission submitted its independent actuarial report *Civil Service Retirement System Cost and Benefit Allocation Principles*,—on the allocation of the CSRS costs and benefits—to Congress, OPM, and the Postal Service.

The report finds that an adjustment of \$50 – \$55 billion in favor of the Postal Service would be equitable and in conformance with current generally accepted actuarial principles and practices.

Currently, OPM, as the administrator of the CSRS, allocates to the Postal Service all residual benefit liabilities in excess of a “frozen” benefit which is calculated based on the accrued pension percentage and final rate of pay as of June 30, 1971, when the Postal Reorganization Act of 1970 (PRA or Pub. L. 91-375) established the Postal Service as an autonomous Federal entity. The costs resulting from the “frozen benefit” calculation are allocated to the Federal government.

The OIG, in its report, *The Postal Service’s Share of CSRS Pension’s Responsibility*, recommends an allocation of benefit liabilities assuming uniform benefit accruals throughout a worker’s career and what it considers an equitable portion of post-1971 salary increases granted to postal employees.

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<sup>11</sup> See U.S. Postal Service Office of Inspector General, Risk Analysis Research Center, *The Postal Service’s Share of CSRS Pension Responsibility*, January 20, 2010.

In its report, in conformance with Financial Accounting Standard Board Accounting Standard Codification 715 (FASB ASC 715) guidance,<sup>12</sup> Segal recommends the continued usage of the CSRS accrual formula for the allocation of costs of benefit payments. However, in lieu of the currently used 1971 postal salaries to determine the Federal government's share of the costs of benefit payments, Segal recommends using the final average "high three" years of Postal Service employees' salaries to determine the Federal government's share. Segal finds both the OIG and OPM's methodologies within the range of acceptable options and notes that the current allocation, though fair and equitable solely within the context of Pub. L. 93-349, overstates the Postal Service's responsibility for CSRS for employees working prior to 1971 by approximately \$50 – \$55 billion according to its proposed methodology.

OPM, in its comments on the Commission report conducted by Segal, stated that in its role as a trust fund administrator and fiduciary, it determines the Postal Service's CSRS costs in compliance with the current law and has no authority to apply another methodology until directed by Congress.<sup>13</sup>

The OIG also issued a report on August 16, 2010, questioning overfunding of the Postal Service's portion of the Federal Employees Retirement System annuity fund.<sup>14</sup> Although neither Congress nor the Postal Service have requested any Commission

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<sup>12</sup> FASB ASC 715, the accounting standard for private industry, requires an allocation methodology using the actual pension plan benefit accrual formula and the impact of future salary increases on current accruals in a "high" or "final" average salary plan.

<sup>13</sup> Letter from United States Office of Personnel Management Director John Berry to Honorable Ruth Y. Goldway, Chairman, Postal Regulatory Commission, September 24, 2010, at 1, 4.

<sup>14</sup> See U.S. Postal Service Office of Inspector General, Management Advisory—Federal Employees Retirement System Overfunding, August 16, 2010.

action based on this report, the President has addressed returning this overfunding to the Postal Service in his FY 2012 budget.<sup>15</sup>

e. Commission Recommendations for Legislative Change

The Commission recommends that Congress adjust the current PSRHBF payment schedule. The PAEA mandated that the Postal Service contribute a payment of \$8.5 billion, including a transfer of \$3 billion from escrow, into the newly established PSRHBF for FY 2007.<sup>16</sup> In its FY 2007 Annual Compliance Report, the Postal Service reported a net loss of \$5.1 billion largely due to these PSRHBF obligations imposed by the PAEA. If not for the PSRHBF obligations, the Postal Service estimates that it would have earned a net profit of \$1.6 billion.<sup>17</sup>

At the time of the passage of the PAEA, the Postal Service enjoyed increasing revenues and a relatively steady volume of mail. Congress expected the Postal Service to be able to continue to make the PAEA mandated PSRHBF payments without compromising its financial health. However, the financial condition of the Postal Service has dramatically changed since the passage of the PAEA. As early as 2007, under the PAEA, the Postal Service reported that meeting its revenue goals was challenging with the changing financial conditions stemming from the market downturn and problems in the financial and housing industries.<sup>18</sup> These changes give rise to the need for a re-evaluation of whether the Postal Service can afford to make these payments as currently scheduled.

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<sup>15</sup> Executive Office of the President of the United States, Fiscal Year 2012 Budget of the U.S. Government, February 14, 2011, at 1282-84.

<sup>16</sup> This was partially offset by the elimination of planned FY 2007 Civil Service Retirement System payment of \$1.6 billion.

<sup>17</sup> See Postal Service Press Release 07-087 (November 15, 2007).

<sup>18</sup> See United States Postal Service Form 10-Q (February 11, 2011) at 20.

The effect of the payments on the Postal Service's cash flow is reflected in the table below.

Table 2

<b>\$ in millions</b>	<b>FY 2006</b>	<b>FY 2007</b>	<b>FY 2008</b>	<b>FY 2009</b>	<b>FY 2010</b>
Employer Premium Expense	1,637	4,684 <sup>†</sup>	1,807	1,990	2,247
Net Income (Loss) Before Pub. L. 109-435 Scheduled payments	900	258	2,794	(2,394)	(3,005)
Pub. L. 109-435 Scheduled Payment		5,400	5,600	1,400	5,500
Net Income (Loss)	900	(5,142)	(2,806)	(3,794)	(8,505)
Cash Balance EOY <b>with</b> Pub. L. 109-435 Scheduled Payments	997	899	1,432	4,089	1,161
Cash Balance EOY <b>without</b> Pub. L. 109-435 Scheduled Payments	997	6,299	7,032	5,489	6,661
Debt Outstanding (from Form 10-K)	2,100	4,200	7,200	10,200	12,000
<sup>†</sup> Employer premium expense of \$1,726 and the transfer of 2006 escrow to the PSRHBF of \$2,958.					

As Table 2 shows, the Postal Service has increased its outstanding debt in order to cover cash payments, including the PSRHBF payments. If not for the PSRHBF payments, the Postal Service would have had more than enough cash flow from operations to cover its expenses without the need to increase debt.

Additionally, it is instructive to compare the funding level of the PSRHBF with other government and private sector entities. As demonstrated in Table 3, the current PSRHBF payment schedule would lead to higher levels of funding than that of many other entities that prefund retiree health benefits.

Table 3

<b>Entity</b>	<b>Funding Level as of FY 2010</b>
United States Postal Service	47%
State Governments that Prefund	18%
Fortune 100 Companies that Prefund	35%
CalPERS <sup>†</sup>	58%
Medicare	<1%
<sup>†</sup> The California Public Employees' Retirement System (CalPERS) is the largest public pension fund in the United States outside of the Federal government. It requires its participating agencies to use a graded trend rate of no more than 10 years with an ultimate rate of between 4 and 6 percent. In its July 30, 2009 report on the Postal Service retiree health benefits, the Commission recommended the use of a 10-year graded rate consistent with CalPERS, the Fortune 100 companies, and State governments with a commonly used ultimate trend rate of 5 percent.	

Modifying the prefunding level and payment schedule should improve the sustainability of the Postal Service as a self-funded independent establishment of the Executive Branch of the Government and help preserve the integrity of the price cap, while maintaining the longer term goal of protecting both taxpayers and future retirees through reasonable prefunding of retiree health benefits.

There are a variety of actuarially sound alternative funding levels that could be set for the PSRHBF. In Table 4 below, the Commission sets forth various actuarially appropriate funding methods. Most of these forecasted FY 2016 scenarios result in significantly higher funding levels than their public and private sector counterparts, and each would provide relief from the current schedule. Table 4 also reports the estimated statutory payments and total statutory payments for FY 2011 through FY 2016 that the Postal Service would have to make at those funding levels.

Table 4

\$ in billions	Current Law		Mercer Report	50% Funded	60% Funded	70% Funded
	Updated FY10	Mercer Report	Updated FY 10	Mercer Report	Mercer Report	Mercer Report
FY 2016 Estimated Liabilities	136	113	127	127	127	127
FY 2016 Estimated Assets	100	83	82	64	75	89
FY 2016 Unfunded Liability	37	31	45	63	51	38
Annual Payment	5.6	3.4	3.4	0.8	2.5	4.5
USPS Statutory Payments FY 2011 - 2016	34	20	20	5	15	27
2016 Percent Funded	73%	73%	64%	50%	60%	70%

Following the Commission's report,<sup>19</sup> OPM adopted assumptions that align closely with the assumptions suggested in the Commission's report with the exception of a longer timeline in reaching the ultimate trend rate for estimated medical inflation. For FY 2010, OPM adopted the Statement of Federal Financial Accounting Standards 33 (SFFAS 33) to estimate the actuarial assumptions underlying the calculation of the retiree health benefits liability.<sup>20</sup> Previously, OPM had relied on guidance from its Board of Actuaries to set these actuarial assumptions.

Congress also should consider the PAEA section 802(c) report<sup>21</sup> on the Postal Service's CSRS liability as a potential remedy for the PSRHBF issues. That report found that the Postal Service's CSRS liability was overstated by approximately \$50 – \$55 billion. This overstated liability was entirely funded by postal ratepayers, not

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<sup>19</sup> Postal Regulatory Commission's Review of Retiree Health Benefit Fund Liability as Calculated by Office of Personnel Management and U. S. Postal Service Office of Inspector General, July 30, 2009.

<sup>20</sup> Statement of Federal Financial Accounting Standards 33: Pensions, Other Retirement Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates.

<sup>21</sup> The Segal Group, Report to the Postal Regulatory Commission on: Civil Service Retirement System Cost and Benefit Allocation Principles, June 30, 2010.

Federal taxpayers. If these excess funds were transferred into the PSRHBF, the fund would be almost fully funded.

## 2. Sarbanes-Oxley Act Compliance

### a. Introduction and Summary

The Sarbanes-Oxley Act was enacted in 2002 as a result of several prominent large corporate financial scandals. Pub. L. 107-204. It was designed to increase corporate responsibility and accountability for reporting materially accurate financial results by requiring management and external auditors' assessment of the effectiveness of internal controls over financial reporting. The PAEA extended section 404 reporting requirements to the Postal Service, and, as discussed below, Congress's inclusion of Sarbanes-Oxley Act reporting requirements in the PAEA and the implementation of those reporting requirements at the Postal Service has resulted in an improvement in transparency and substantial cost savings.

### b. Pre-PAEA Financial Reporting of the Postal Service

Prior to the passage of the Sarbanes-Oxley Act provisions in the PAEA, the Postal Service established an Internal Control Group (ICG) in 2003 to assure compliance with Postal Service policies and processes related to reporting financial results. This initiative was undertaken pursuant to the financial systems reforms proposed by the Committee of Sponsoring Organizations of the Treadway Commission and later embodied in the Sarbanes-Oxley Act of 2002. The Postal Service's ICG voluntarily implemented parts of Sarbanes-Oxley Act on its own initiative.

### c. The PAEA's Sarbanes-Oxley Act Requirements

Under the PAEA, beginning with FY 2010, the Postal Service must comply with section 404, which effectively also mandates compliance with section 302. The PAEA mandated Sarbanes-Oxley Act reports must be prepared in accordance "with the rules

prescribed by the Securities and Exchange Commission,” and must be filed with the Postal Regulatory Commission. 39 U.S.C. 3654(a)(3). The Postal Service is only Federal governmental entity required to comply with this legislation.

Section 404 requires that all annual financial reports must include an Internal Control Report stating that management is responsible for an “adequate” internal control structure and an assessment by management of the effectiveness of the control structure. Any shortcomings in these controls must also be reported. In addition, registered external auditors must attest to the accuracy of the company management’s assertion that internal accounting controls are in place, operational, and effective. 15 U.S.C. 7262.

Section 302 requires a company’s CEO and CFO to personally certify that the reports are a fair representation of the entity’s financial position and result of operations. This requires the officers to take ownership for establishing and maintaining effective disclosure controls and procedures. 15 U.S.C. 7241.

Since FY 2010, Postal Service management has reported annually on the effectiveness of their internal control over financial reporting. An independent auditor renders an opinion on the effectiveness of the Postal Service’s internal control over financial reporting and management’s assessment of it.

d. Evaluation of the Sarbanes-Oxley Act Under the PAEA

The PAEA’s implementation of section 404 of the Sarbanes-Oxley Act has aided in the standardization and streamlining of business practices, processes, and systems. It has enabled timely identification and remediation of weaknesses, increased accountability and fostered ownership of controls. The Postal Service’s FY 2010 Form 10-K received a clean opinion from auditors,<sup>22</sup> and the Postal Service indicated that

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<sup>22</sup> See United States Postal Service Form 10-K (November 15, 2010) at 53.

Sarbanes-Oxley Act implementation resulted in substantial indirect cost savings through the strengthening of controls over business mail processes, including the prevention of lost revenue.<sup>23</sup> Additionally, the Postal Service was able to implement the Sarbanes-Oxley Act well before the 60-day deadline for filing its annual report. On November 15, 2010, the Postal Service filed as an attachment to its FY 2010 Form 10-K, the required Sarbanes-Oxley Section 302 certifications and its external auditor assessment that the internal controls over its financial reporting were effective.

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<sup>23</sup> See Sarbanes-Oxley (SOX) Compliance Audits Next Steps, MTAC Meeting, February 16, 2011.

## C. Rate and Service Matters

### 1. Market Dominant Price Cap

#### a. Introduction and Summary

The Commission finds that the annual rate limitation for market dominant products as expressed by the price cap has kept prices stable and predictable since the passage of the PAEA. Pursuant to 39 U.S.C. 3622(d)(2), the Commission will conduct a more in-depth review of the price cap in 2016, 10 years after the passage of the PAEA.

This section briefly discusses the price adjustment process prior to the passage of the PAEA, and then explains how the PAEA has changed the process with the addition of the price cap. Next, it describes the Commission's experience with the price cap. Based on that experience, the Commission finds that no legislative changes are needed with respect to the price cap. The Commission recommends that Congress consider providing an opportunity for the Postal Service to achieve increased pricing authority for increases in quality of service.

#### b. Price Adjustments Prior to the PAEA

Prior to the passage of the PAEA, price adjustments reflected changes in projected costs of service.<sup>24</sup> Forecasts of costs, volumes, and revenues were used to establish proposed prices that would generate sufficient revenues to recover costs.

The former price adjustment process started with a proposed rate adjustment by the Postal Service. The Postal Service's proposal was then subject to formal,

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<sup>24</sup> A cost of service adjustment is when prices are set based on the cost of providing a service. Under the PRA, revenues received from prices charged had to approximate the costs of providing the service.

adversarial litigation before the Postal Rate Commission. Based on the record developed during a 10-month period, the Commission recommended prices in its Opinion and Recommended Decision. The Postal Service's Governors had several options upon their review of the Commission's recommended prices. Typically, the rates recommended by the Commission were the rates that went into effect.

c. PAEA Market Dominant Price Adjustments

A primary goal of the PAEA is to provide stable and predictable rates while promoting efficiency by applying the price cap to each market dominant class of mail.<sup>25</sup> It gives the Postal Service flexibility regarding the timing and the size of price adjustments for products within a class. It simplified and accelerated the price adjustment process for the Postal Service. It provides for annual limitations on the percentage change in rates for classes of mail. 39 U.S.C. 3622(d)(1). In general, the average rate increase for mail within a class cannot exceed the increase in the Consumer Price Index for All Urban Consumers (CPI-U) unadjusted for seasonal variation. 39 U.S.C. 3622(d)(1), (2). When a price adjustment is less than the price cap, the Postal Service may "bank" unused rate adjustment authority for up to five years. 39 U.S.C. 3622(d)(2)(C). The Postal Service can utilize banked authority for each class in future price adjustments to achieve a price adjustment greater than the price cap.<sup>26</sup>

The Postal Service must also provide schedules of rates that change at regular intervals and by predictable amounts. 39 U.S.C. 3622(d)(1)(B). On January 13, 2011, the Postal Service filed an updated schedule of price adjustments, indicating that it

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<sup>25</sup> There are five market dominant classes of mail. Typically, each class has a defining characteristic. For example, First-Class Mail is sealed against inspection.

<sup>26</sup> 39 U.S.C. 3622(d)(2)(C) allows the Postal Service to use banked authority from part of or more than 1 year, requires the earliest banked authority to be used first, and limits the use of banked authority to 2 percentage points per year.

would file price adjustments in mid-January of each year, with a mid-April implementation date.<sup>27</sup>

In addition, the Postal Service may request price increases that exceed the price cap when an extraordinary or exceptional circumstance necessitates a price adjustment greater than the price cap. Such a request is reviewed in 90 days by the Commission. The Postal Service filed for an exigent price adjustment on July 6, 2010 (Docket No. R2010-4), which was denied by the Commission on September 30, 2010. The Postal Service appealed the Commission's decision in that case, and the appeal was ruled on by the United States Court of Appeals for the District of Columbia on May 24, 2011. The court remanded the exigent price adjustment decision, in part, to the Commission to address how closely an exigent price adjustment must financially offset the extraordinary or exceptional circumstance. The Commission is currently reviewing the court's decision and determining how to proceed on remand. See Docket No. R2010-4R.

d. Effectiveness of the Price Cap

(1) Price Adjustments Using the Price Cap

Since the passage of the PAEA, there have been three generally applicable price adjustments. The price cap limitation for these price adjustments are shown in Table 5. In each price adjustment the Postal Service has increased prices for each class almost equal to the price cap limitation.

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<sup>27</sup> Previously, the Postal Service filed price adjustments in mid-February with a mid-May implementation.

Table 5

**PAEA Price Cap Adjustments**

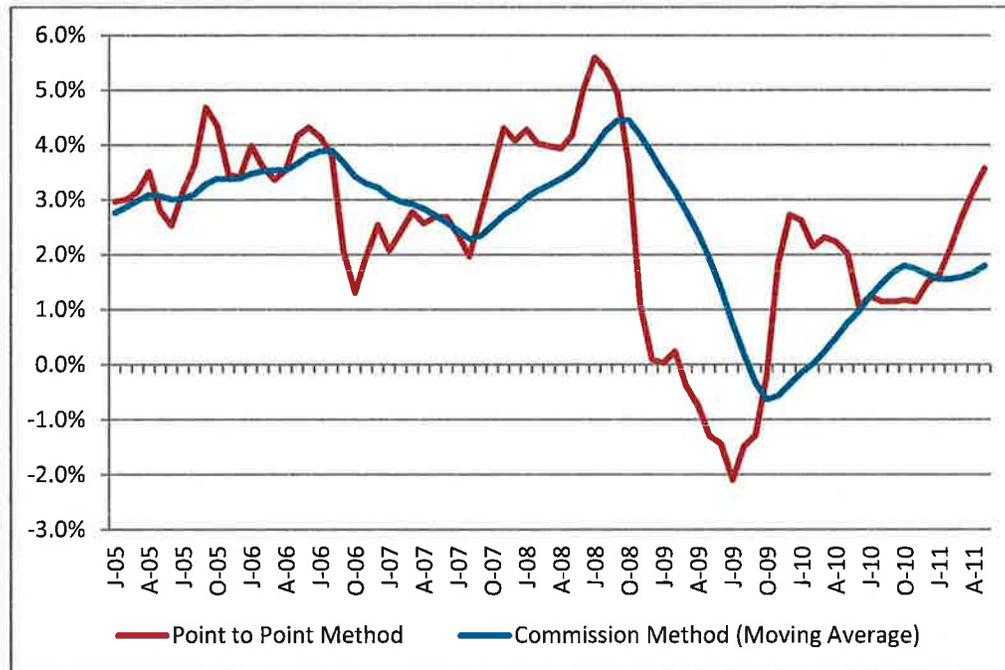
<b>Docket No.</b>	<b>Date Filed</b>	<b>Price Cap</b>
<b>R2008-1</b>	February 11, 2008	2.9 percent
<b>R2009-2</b>	February 10, 2009	3.8 percent
<b>R2011-2</b>	January 13, 2011	1.741 percent <sup>†</sup>
<sup>†</sup> The number of decimal places in the price cap was changed in Docket No. RM2009-8 to include three decimal places rather than one decimal place.		

39 U.S.C. 3622(d)(A) explains that the annual limitation on the percentage change in rates is equal to the change in the CPI-U unadjusted for seasonal variation over the most recent 12-month period preceding the date the Postal Service files notice of its intention to increase rates. The Commission's rules implement this requirement by calculating the price cap as the difference between two 12-month averages of the CPI-U.<sup>28</sup> Using 12-month averages to calculate the price cap removes some of the volatility present when a point-to-point comparison is done with monthly CPI-U values. As shown in Chart 1, the Commission's use of 12-month averages creates peaks that are not as high, and troughs that are not as low, which promotes the PAEA goals of predictability and stability in prices.

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<sup>28</sup> The calculation of the price cap is explained in greater detail in 39 CFR 3010.21.

Chart 1  
**Percentage Change in CPI-U  
 Commission 12-Month Average Method and  
 Monthly Point-to-Point Method**



One point of tension regarding the price cap is deflation. As shown in Chart 1, the price cap was below zero from September 2009 through January 2010. Therefore, if the Postal Service remained on its price adjustment schedule, it would have filed a price adjustment using the December 2009 price cap which would not have allowed it to raise rates. Instead, the Postal Service waited 23 months after the prior price adjustment to request an adjustment in rates.

While the Postal Service typically files price adjustments annually, the Commission's rules are designed to accommodate price adjustments that are either less than or more than 12 months apart. For price adjustments that occur more than 12 months apart, the Commission calculates the price cap for the previous 12-month period. Any prior unused rate adjustment authority is banked. Table 6 shows the

12-month averages (*i.e.*, indices) that were used to calculate the price cap in Docket Nos. R2008-1 and R2009-2, the interim banked authority in Docket No. R2011-2, and the price cap in Docket No. R2011-2. As shown in Table 6, the Commission's calculation ensures that every month of CPI-U is either included in a price cap calculation or is classified as interim banked authority.

Table 6  
**Docket Nos. R2008-1, R2009-2 and R2011-2  
 Price Caps and Interim Banked Authority**

<b>Docket No.</b>	<b>Numerator</b>	<b>Denominator</b>	<b>Result</b>
R2008-1 Price Cap	December 2007 Index	December 2006 Index	2.9%
R2009-2 Price Cap	December 2008 Index	December 2007 Index	3.8%
R2011-2 Interim Banked Authority	November 2009 Index	December 2008 Index	-0.577%
R2011-2 Price Cap	November 2010 Index	November 2009 Index	1.741%

The interim banked authority in Docket No. R2011-2 was negative. The Postal Service's pricing flexibility allows it to either use this negative interim banked authority in a future price adjustment, by increasing rates less than the price cap, or let it expire in five years pursuant to 39 U.S.C. 3622(d)(2)(C)(ii) and 39 CFR 3010.26(d).<sup>29</sup>

At the class level, prices are not allowed to increase above the price cap taking into account any available banked authority. However, within classes, the Postal Service has the flexibility to give products above-average and below-average price

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<sup>29</sup> Some postal stakeholders believe that the Postal Service should be required to decrease the price cap equal to the interim banked authority, *i.e.*, add the Docket No. R2011-2 interim banked authority and price cap to arrive at a smaller overall price cap. See, *e.g.*, Docket No. R2011-1, Comments of the Affordable Mail Alliance, November 24, 2010. The Commission found that such an approach would be contrary to the statute and inappropriately reduce the pricing flexibility of the Postal Service. The Commission's rules appropriately address CPI deflation as well as properly maintain the pricing flexibility of the Postal Service as mandated by the PAEA.

adjustments. Typically, products with low cost coverages<sup>30</sup> receive above-average increases in an attempt to improve the profitability of the product.

For example, the Package Services class failed to generate sufficient revenues to recover costs in FY 2009 and FY 2010. Within the Package Services class, Bound Printed Matter Flats is the only product that has consistently had a cost coverage above 100 percent since the passage of the PAEA, and it has always received below-average price increases. Conversely, the Media/Library Mail product has had a below 100 percent cost coverage since the passage of the PAEA; therefore, the product has received above-average price increases in each price adjustment to improve its cost coverage. The Commission finds that this is an effective use of the Postal Service's pricing flexibility.

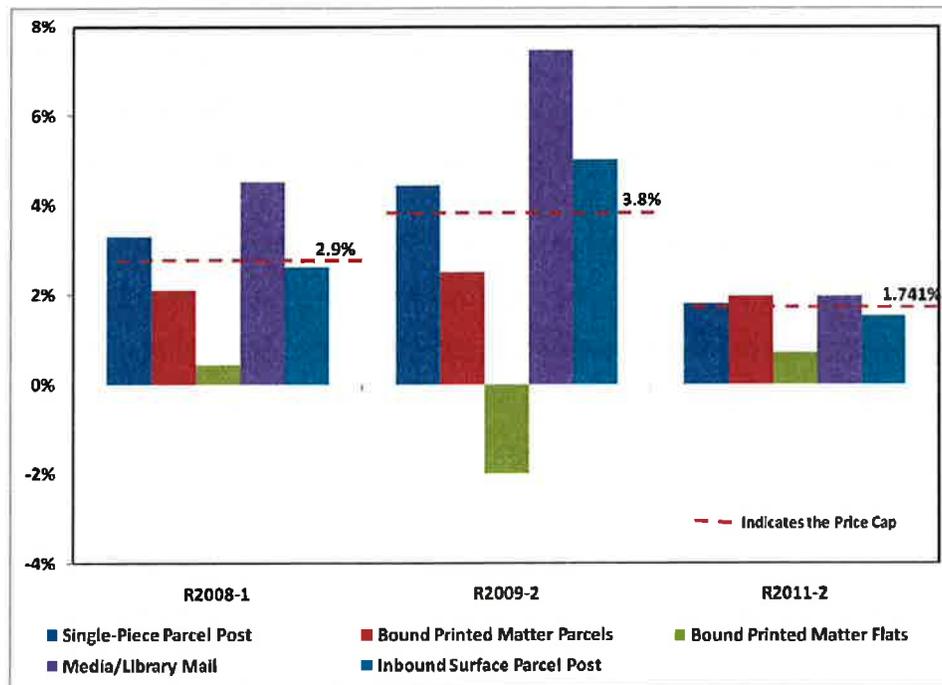
In Chart 2, the percentage changes in prices for the products within the Package Services class are shown.

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<sup>30</sup> Cost coverage is the ratio of revenues and costs for a product. If a cost coverage is over 100 percent, revenues exceed costs.

Chart 2

### Percentage Change in Prices by Product for the Package Services Class



While the Postal Service has used its pricing flexibility to address products that do not cover costs in some instances, it has not done so in other cases. The Commission finds that the Postal Service could utilize this flexibility more broadly. For instance, in its most recent ACD, the Commission found that the Postal Service had not made sufficient use of its pricing flexibility to address the subsidy of unprofitable Standard Mail flats by users of other Standard Mail products despite repeated encouragement. FY 2010 ACD, March 29, 2011, at 102-03, 106. The Commission highlighted the fact that since 2008, the Postal Service continually failed to use its within-class pricing flexibility to correct this inequity by giving Standard Mail Flats mailpieces below-average price increases while giving other profitable products higher than average price increases. *Id.* at 106.

## (2) Exigent Price Adjustments

As noted, the PAEA provides an exception to the price cap known as an exigent price adjustment, which allows for price adjustments in excess of the price cap. In July 2010, the Postal Service filed the first ever request for an exigent price adjustment (Docket No. R2010-4). The Postal Service asked the Commission to find that raising prices above the price cap for all its market dominant classes of mail by an average of 5.6 percent was appropriate due to extraordinary or exceptional volume declines.

The Commission unanimously denied the Postal Service's request for an exigent price increase. The Commission found that the recent recession and the decline in mail volume experienced during the recession, qualified as an extraordinary or exceptional circumstance. However, the Commission also found that a determination that "extraordinary or exceptional circumstances" have occurred is not by itself sufficient to authorize a price increase in excess of the price cap. The Commission cited the need for two additional requirements. First, the proposed adjustment must be "due to" the extraordinary or exceptional circumstances. Second, "such adjustment" (*i.e.*, the adjustment due to extraordinary or exceptional circumstances) must meet a "reasonable and equitable and necessary" test.<sup>31</sup> The Postal Service made no attempt to relate the requested exigent price adjustment to the impact of the recent recession. Rather, the request was explained as an attempt to address financial conditions and long-term structural problems not caused by the recent recession.

The Commission concluded that the PAEA limits exigent price adjustments to those amounts "due to" specific extraordinary or exceptional circumstances. It found that the Postal Service's failure to quantify the impact of the recession on postal finances or to address how the requested price adjustment related to the recession's impact on postal volumes and revenues necessitated the Commission to deny the

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<sup>31</sup> 39 U.S.C. 3622(d)(1)(E).

Postal Service's request. The Postal Service appealed the Commission's decision, and the appeal was ruled on by United States Court of Appeals for the District of Columbia Circuit on May 24, 2011. The court affirmed that the Postal Service had not shown its proposed price increases were due to the exigent circumstance, but remanded the matter to the Commission to clarify how closely an exigent price adjustment must financially offset the extraordinary or exceptional circumstance. The Commission has since initiated Docket No. R2010-4R to respond to the court's ruling.

### (3) Schedule of Price Adjustments

The PAEA allows the Postal Service the flexibility to request price adjustments when it deems them necessary and appropriate. These adjustments are required to be at regular intervals and by predictable amounts. See 39 U.S.C. 3622(d)(1)(B). The Postal Service must file price adjustments with the Commission at least 45 days before the prices are effective.<sup>32</sup> As discussed above, since the passage of the PAEA, the Postal Service has filed three price adjustments that required the application of the price cap. Table 6 details these requests. The filing of each of these price adjustments has occurred after the Postal Service filed its Annual Compliance Report (ACR) with the Commission. The filing of the Postal Service's ACR is fixed pursuant to 39 U.S.C. 3652(a) and must be filed 90 days after the end of the Postal Service's fiscal year. The Commission's ACD is then due 90 days later. This means that when the Postal Service files a price adjustment during January or February, the Commission must review the Postal Service's price adjustments prior to issuing its ACD. This is the schedule that has existed in each review of generally applicable price adjustments requested by the Postal Service since the passage of the PAEA.

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<sup>32</sup> The Postal Service typically provides mailers with at least 90 days notice before implementation.

The Commission appreciates that the Postal Service has chosen to file price adjustments in January after it files its ACR. Filing price adjustments in the second quarter of the fiscal year ensures that the most up-to-date cost data are available when prices, product cost coverages, and workshare discounts are proposed by the Postal Service and reviewed by the Commission. The Postal Service filing of price adjustments in the months immediately preceding the filing of its ACR in any year would be problematic.<sup>33</sup>

Filings in October, November and December mean that available cost data are more than one year old. Soon after the new prices are effective, the Postal Service would file its ACR with updated cost data, which could reveal that prices were not set in accordance with Commission rules. For example, the updated costs could show that workshare discounts were set too low or too high or that a product no longer covers costs, which may have warranted an above-average price increase in the recent price adjustment. Every month after January the Postal Service's cost data become less reliable.

However, the Postal Service's current schedule imposes some difficulties on postal stakeholders as well as the Commission. When the Postal Service files a price adjustment in mid-January, postal stakeholders and the Commission have only 2 weeks to review the Postal Service's most recent ACR data. Issues have arisen in the past where the Postal Service did not use proper analytical methodologies in the original ACR filings, which affects the final numbers filed in the Postal Service's ACR.<sup>34</sup> Since

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<sup>33</sup> The Postal Service has advised mailers that the next price adjustment for market dominant products will take effect January 22, 2012. See Association of Postal Commerce Postal Bulletin 25-11, June 17, 2011 at 16. However, the Postal Service's official filing with the Commission pursuant to 39 CFR 3010.7 states that the next price adjustment is expected to take place mid-April of each subsequent year. See Docket No. R2011-2, United States Postal Service Filing of Updated Schedule of Regular and Predictable Price Changes, January 13, 2011.

<sup>34</sup> See, e.g., 2010 ACD at 110.

the Postal Service currently uses the ACR data to design its prices, its price adjustments may not reflect the same accurate, timely data underlying the final numbers approved in the Commission's ACD.<sup>35</sup> This could also cause harm to the time-sensitive process which allows mailers and members of the public to comment on the Postal Service's ACR to inform the Commission's review and findings in its annual ACD.

e. Commission Recommendations

(1) Generally Applicable Price Adjustments

The Commission finds that, in furtherance of the PAEA's goals, the use of the price cap promotes pricing flexibility for the Postal Service; predictability and stability in prices for mail users; and encourages cost reductions for the Postal Service. The Commission recommends no legislative changes in this area. As discussed previously, the Commission will conduct a more extensive review of the price cap in 2016, 10 years after the passage of the PAEA pursuant to 39 U.S.C. 3622(d)(2).

(2) Exigent Price Adjustments

The Commission finds that the current exigent price adjustment process is effective and efficient. The Postal Service must request a proposed adjustment, with sufficient justification, and the Commission is required to make the final determination on the proposal. This balanced approach ensures exigent price adjustments occur only in appropriate circumstances.

The Commission does not recommend any legislative changes regarding exigent price adjustments at this time.

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<sup>35</sup> While in many circumstances, the final numbers approved by the Commission in its ACD reflect those filed by the Postal Service in its ACR, the Commission may have to make adjustments in its ACD to those calculations made by the Postal Service in its ACR. For example, when the Postal Service did not use proper analytical methodologies in the original ACR filings, the Commission had to make such adjustments in its ACD. *Id.*

### (3) Schedule of Price Adjustments

The Commission finds the current schedule of price adjustments (mid-January request with mid-April implementation) and their correlation with the filing of the ACR is proper. The Commission does not recommend any changes.

### (4) Service Adjustments

While the Commission has not vetted this concept, Congress should consider allowing the Postal Service to obtain increased pricing flexibility for quality of service enhancements. Congress could legislatively provide additional rate adjustment authority to the Postal Service if it increases the quality of its service performance for a particular class of mail. Such service quality pricing authority would provide an incentive for the Postal Service to increase the service performance of its products. Currently, there are no direct financial incentives for the Postal Service to increase the service performance of its products and services.

Under a service rate adjustment, mailers would receive a corresponding improvement in service to go along with any increase in price. To ensure that increases in service merit increases in rate adjustment authority, the Commission should be required to review and make determinations on the amount of service increased price adjustment authority that the Postal Service obtains for any particular service change. This recommendation is further discussed in chapter IV.C.5., Service Performance Measurement and Customer Satisfaction. Such a mechanism should be used only in a positive manner, providing encouragement for the Postal Service to consider increasing service quality.<sup>36</sup>

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<sup>36</sup> For example, should Congress make a determination that the Postal Service be allowed to reduce the number of delivery days per week, the Commission is not suggesting that Congress require a corresponding decrease in prices.

## 2. Market Dominant Classes of Mail

### a. Introduction and Summary

The PAEA requires the Commission to maintain a product list that categorizes postal products as market dominant or competitive. Pursuant to 39 U.S.C. 3642(a), products can be added, removed, or transferred from the market dominant or competitive product lists. Market dominant products are grouped into classes, which 39 U.S.C. 3622(d)(2)(A) defines as the classes listed in the Domestic Mail Classification Schedule as of the date of enactment of the PAEA. The market dominant classes of mail are:

- First-Class Mail;
- Periodicals;
- Standard Mail;
- Package Services; and
- Special Services.

The price cap is applied at the class level, as the classes were defined on the date of enactment of the PAEA. 39 U.S.C. 3622(d)(2). Although new products may be added, the PAEA is silent as to whether new classes of mail can be added. This significantly limits the Postal Service's flexibility. The Commission recommends that the PAEA be enhanced by explicitly allowing the Postal Service to add new classes of mail.

### b. Classes of Mail Pre- and Post-PAEA

Prior to the passage of the PAEA, the same five classes listed above were used by the Postal Service to group its levels of service offerings.<sup>37</sup> Each class was divided

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<sup>37</sup> In addition to the five market dominant classes listed above, the former Domestic Mail Classification Schedule had a class of mail called "Expedited Mail" which consisted of Postal Service offerings that are now classified as competitive.

into subclasses of mail. Typically, each class of mail had at least one defining characteristic. For example, First-Class Mail is sealed against inspection.

The PAEA allowed the Postal Service to re-categorize mail into products. These products were then placed either on the market dominant product list or the competitive product list. Market dominant products remained within their former classes.

c. Changes to Products and Classes Under the PAEA

Since the passage of the PAEA, the Postal Service has used its new classification flexibility to transfer products from the market dominant product list to the competitive product list. See, e.g., Docket No. MC2008-4: Transferring Premium Forwarding Service to the Competitive Product List; see also, e.g., Docket No. MC2010-36: Transferring Commercial Standard Mail Parcels to the Competitive Product List. When a product or rate category is transferred from the market dominant product list to the competitive product list, price adjustments are no longer limited by the price cap.<sup>38</sup> Such a transfer increases the Postal Service's pricing flexibility for that product.

The criteria for defining a product as market dominant are whether:

the Postal Service exercises sufficient market power that it can effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products.

39 U.S.C. 3642(b)(1).

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<sup>38</sup> Competitive products must meet the requirements of 39 U.S.C. 3633, which prohibit the subsidization of competitive products; require that each competitive product covers its costs; and requires that competitive products collectively cover what the Commission determines to be an appropriate share of institutional costs (currently 5.5 percent).

The Commission is required to consider the availability and nature of enterprises in the private sector engaged in the delivery of the product, the views of those that use the product, and the likely impact on small business concerns. 39 U.S.C. 3642(b)(3). The Commission rules implementing section 3642 require the Postal Service to provide data and supporting justification when requesting the addition, removal, or transfer of a product. 39 CFR 3020.30 *et seq.* Postal products not defined as market dominant are classified as competitive.

Unlike the creation, removal, or transfer of products, the PAEA is silent on whether new market dominant classes can be created as the needs of the Postal Service and mailers change over time. Rather, it states that the price cap applies “to a class of mail, as defined in the Domestic Mail Classification Schedule as in effect on the date of enactment of the Postal Accountability and Enhancement Act.” 39 U.S.C. 3622(d)(2). This provision could be read as barring the Postal Service from creating new classes of products. Indeed, thus far, the Postal Service has not attempted to create a new class of mail. This apparent inability of the Postal Service to create new classes significantly limits the Postal Service’s flexibility to adapt to changed circumstances in our postal system.

In the future, the Postal Service and mailers may determine that it is in their best interests to create a new class of mail that has some characteristics of First-Class Mail and some characteristics of Standard Mail. For example, such a class could be set up to offer the speed of First-Class Mail delivery without free mail forwarding or other First-Class Mail attributes. Presumably, the rates for such a service would fall somewhere between the rates of First-Class Mail and Standard Mail. Mailers who currently send Standard Mail mailpieces may appreciate the increased benefits of the new class and pay higher rates for such service. However, the current rigid class structure for market dominant products discourages these types of innovative ideas and hinders the Postal Service’s flexibility.

#### d. Commission Recommendations

The Commission recommends that the PAEA be enhanced to explicitly allow the Postal Service to add new classes of mail. To prevent unintended consequences and harm to mail users, such increased Postal Service flexibility should be balanced with an appropriate level of Commission oversight. If Congress decides to provide the Postal Service with an explicit grant of flexibility to add new classes of mail, the Commission should be required to approve such proposals and evaluate how the change would affect other products as well as the objectives and factors of 39 U.S.C. 3622. The Commission's review will ensure, among other things, that a proposed new class is not designed to hamper predictability and stability in prices or to benefit or harm any specific mailer or group of mailers. This legislative enhancement will ensure that the Postal Service is equipped to adapt to the rapidly changing needs of mail users and the postal system.

### 3. Nonpostal Services

#### a. Introduction and Summary

The Commission finds that the review and oversight mechanisms created by the PAEA over the Postal Service's grandfathered nonpostal services have resulted in a positive increase in the accountability and transparency of these service offerings. Given this track record, if Congress allows the Postal Service to offer new, nonpostal services, it should subject such services to appropriate regulatory review and oversight.

Below, the Commission outlines the legal framework under which the Postal Service offered nonpostal services prior to the enactment of the PAEA. Next, the Commission discusses the significant changes in the legal landscape that were made by the PAEA with respect to nonpostal service offerings and the Commission's new statutory role in that process with respect to grandfathered nonpostal services. The Commission then focuses on its experiences with grandfathered nonpostal services.

Finally, based on the Commission's experience with grandfathered nonpostal services, it addresses its recommendations for legislative change with respect to new, nonpostal services.

b. Nonpostal Service Offerings Pre-PAEA

Prior to the passage of the PAEA, the Postal Service had virtually limitless discretion to offer nonpostal services. In former 39 U.S.C. 404(a)(6), Congress granted the Postal Service the specific power to "provide, establish, change, or abolish special nonpostal or similar services." The Postal Service set the rates and fees for these "nonpostal or similar services" exclusively. The Postal Rate Commission was not involved in the rate and fee setting process and nonpostal service offerings were not subject to regulatory oversight. As such, there was practically no transparency in the determination of those rates or whether such rates were profitable.

In rate cases under the PRA, the Postal Service provided some aggregated revenue data to the Postal Rate Commission in response to questions asked by the Commission in the context of those cases. However, cost accounting information for those services was not provided since the Postal Rate Commission was not setting the rates or prices for the items. For purposes of ratemaking for postal services, nonpostal

revenues were simply considered as part of miscellaneous, "other revenue," when calculating the revenue requirement.<sup>39</sup>

Under this prior statutory framework, the Postal Service had a history of pursuing a variety of nonpostal business ventures. In total, these ventures, particularly those related to electronic commerce, were found to be unprofitable in the late 1990s and early 2000s by the General Accounting Office<sup>40</sup> and the 2003 President's Commission on the Future of the Postal Service.<sup>41</sup> GAO reported that electronic commerce services lost \$20.3 million from product inception through fiscal year 1997.<sup>42</sup> Additionally, GAO reported that none of the e-commerce initiatives for which financial information was

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<sup>39</sup> Before the passage of the PAEA, the PRA established the basic principles on which postal rates were set. The primary requirement was that the Postal Service attained financial "breakeven." That is, postal rates and fees needed to provide enough revenues so that total postal revenues equaled as nearly as practicable the total costs. For a pre-PAEA rate case, the breakeven requirement was applied for a single prospective year. The revenue requirement was the total required revenue for that single prospective year. The revenue requirement included: (1) projected operating costs in the test year, (2) an amount to offset prior operating losses; and (3) a contingency amount. "Other revenue" was generally considered to be a direct offset to the revenue requirement.

<sup>40</sup> The General Accounting Office was renamed the Government Accountability Office in 2004, referenced in this document as GAO. See Pub. L. 108-271 (2004).

<sup>41</sup> See *U.S. Postal Service: Development and Inventory of New Products*, GAO/GGD-99-15 (Washington, D.C. November 24, 1998) requested by Congressman John M. McHugh, Chairman, Subcommittee on the Postal Service, Committee on Government Reform and Oversight (GAO-02-79); *U.S. Postal Service: Update on E-Commerce Activities and Privacy Protections*, GAO-02-79 (Washington, D.C.: Dec. 21, 2001) requested by Senator Thad Cochran, Ranking Member Subcommittee on International Security Proliferation, and Federal Services, Committee on Government Affairs; *U.S. Postal Service: Postal Activities and Laws Related to Electronic Commerce*, GAO/GGD-00-188 (Washington, D.C.: Sept. 7, 2000) requested by Senator Thad Cochran, Chairman, Subcommittee on International Security Proliferation, and Federal Services, Committee on Government Affairs (GAO/GGD-00-188); see also *Embracing the Future: Making the Tough Choices to Preserve Universal Mail Service*, Report of the President's Commission on the United States Postal Service, (Jul. 31, 2003), at 27-28 (Embracing the Future Report).

<sup>42</sup> See GAO/GGD-99-15.

provided for the 3rd quarter of fiscal year 2001 were profitable.<sup>43</sup> Moreover, GAO also found that the Postal Service's entry into these markets resulted in distortion of private markets and diversion of Postal Service resources from its core responsibility of delivering hard copy mail.<sup>44</sup>

c. The PAEA Statutory and Regulatory Requirements for Nonpostal Services

The PAEA repealed the Postal Service's authority to offer "nonpostal services" and prohibited the offering of any new nonpostal services. See PAEA section 102. It also mandated that the Postal Service could only continue to offer grandfathered nonpostal services that met certain statutory criteria.<sup>45</sup>

Specifically, the PAEA tasked the Commission with reviewing each nonpostal service offered by the Postal Service to determine whether that nonpostal service should be allowed to continue. 39 U.S.C. 404(e)(3). In making such a determination, the statute required the Commission to take into account "(A) the public need for the service; and (B) the ability of the private sector to meet the public need for the service." *Id.* Services that continue were required to be designated and regulated as either a market dominant product, a competitive product, or an experimental product. 39 U.S.C. 404(e)(5).

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<sup>43</sup> *U.S. Postal Service: Update on E-Commerce Activities and Privacy Protections*, GAO-02-79 (Washington, D.C. Dec. 21, 2001, at 17 requested by Senator Thad Cochran, Ranking Member Subcommittee on International Security Proliferation, and Federal Services, Committee on Government Affairs.

<sup>44</sup> See GAO/GGD-99-15, GAO-02-79 and GAO/GGD-00-188.

<sup>45</sup> See PAEA section 102; 39 U.S.C. 404(e).

d. Grandfathered Nonpostal Services

In implementing its statutory responsibility under 404(e)(3), the Postal Regulatory Commission initiated Docket No. MC2008-1 on December 20, 2007 to receive evidence on the Postal Service's nonpostal services being offered as of the date of enactment of the PAEA in order to determine whether those services should continue. Upon receipt of that evidence, the Commission allowed several rounds of briefings by interested participants. The Commission found that the following nonpostal services should be allowed to continue:

- Market Dominant Nonpostal Services
  - MoverSource
  - Philatelic Sales
- Competitive Nonpostal Services<sup>46</sup>
  - Affiliates for Website
  - Affiliates – Other (Linking Only)
  - Electronic Postmark Program
  - Officially Licensed Retail Products
  - Meter Manufacturers Marketing Program
  - Non-Sale Lease Agreements (Non-Government)
  - Licensing Programs other than Officially Licensed Retail Products
  - Passport Photo Service
  - Photocopying Service
  - Training Facilities

See *generally* Order No. 154.<sup>47</sup> In this case, the Commission also signaled its intent to regulate these nonpostal activities in accordance with the requirements of section

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<sup>46</sup> In Order No. 154, the Commission left open the issue of whether to allow the following nonpostal activities to continue (1) the licensing of mailing and shipping supplies; (2) the warranty repair program; and (3) the sale of CDs and DVDs as part of its authorized nonpostal service, Officially Licensed Retail Products Program. See Docket No. MC2008-1, Review of Nonpostal Services Under the Postal Accountability and Enhancement Act, December 19, 2008 (Order No. 154). Those issues were decided in Phase II of Docket No. MC2008-1.

<sup>47</sup> This list has been updated from that in Order No. 154 to reflect the Postal Service's proposal in Docket No. MC2010-24.

404(e)(5) in a “light-handed” manner. *Id.* at 68, 88. A Federal appeals court affirmed this Commission decision. See *USPS v. PRC*, 599 F.3d 705 (D.C. Cir. 2010).

The Commission initiated Phase II of Docket No. MC2008-1 to resolve issues with respect to three nonpostal services that it could not fully evaluate in Phase I.<sup>48</sup> For differing reasons, the Commission concluded that (1) the licensing of mailing and shipping supplies should not be part of the competitive nonpostal service of licensing; (2) the warranty repair program should not continue; and (3) the sale of CDs and DVDs should be discontinued. On appeal, the United States Court of Appeals for the District of Columbia Circuit remanded to the Commission for further consideration the issue of licensing the Postal Service’s logo for use on mailing and shipping supplies in *LePage’s 2000, Inc. and LePage’s Products, Inc. v. PRC*, 10-1031, slip op. at 1 (D.C. Cir. June 7, 2011). The Commission is currently reviewing the court’s decision.

e. Commission Experience with the Nonpostal Services

In the Commission’s most recent Annual Compliance Determination of the Postal Service, the Commission found that the grandfathered nonpostal services generated \$430.6 million in revenue and incurred \$256.1 million in expenses resulting in a net income of \$174.5 million.<sup>49</sup> The Commission also found that the Postal Service did not properly separate financial data for postal services from nonpostal services for certain

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<sup>48</sup> See Docket No. MC2008-1 (Phase II), Order No. 168, January 9, 2009.

<sup>49</sup> Ongoing, systematic reporting and assessment of the financial and operational performance of the United States Postal Service are mandated by two provisions of the PAEA. The first provision, 39 U.S.C. 3652, requires the Postal Service to file certain annual reports with the Commission, including an ACR. See 39 U.S.C. 3652(a) and (g). The second provision, 39 U.S.C. 3653, provides for the Commission’s review of these annual reports, and issuance of an ACD regarding the compliance or non-compliance of various rates and service standards. Together, these provisions establish the ACD and the ACR as integrated mechanisms for achieving the PAEA’s objective of ongoing accountability, transparency, and oversight. The Commission’s most recent ACD analyzed fiscal year 2010. See Annual Compliance Determination of the United States Postal Service for Fiscal Year 2010, Postal Regulatory Commission, March 29, 2011, at 151-52.

products, and it directed the Postal Service to alter the way it reports this data in the future to come into accord with applicable legal requirements.

f. Commission Recommendations for Legislative Change

The Commission recognizes that there are several legislative proposals that would allow the Postal Service to offer new, nonpostal services in addition to those grandfathered nonpostal services. If Congress decides to allow the Postal Service to offer such services, it should include adequate safeguards to reduce the potential for unprofitable nonpostal business ventures. In addition, such safeguards should ensure that the Postal Service's entry into nonpostal markets will not distort private markets or divert Postal Service resources from its core responsibilities.

Toward that end, the Commission recommends that if the Postal Service is allowed to offer certain new, nonpostal services, these services be subject to the same regulatory review that the Postal Regulatory Commission applied to determining whether to grandfather a nonpostal service under section 404(e)(3). Such an approach would apply the section 404(e)(3) test to new nonpostal services and require the Commission, in determining whether to allow the Postal Service to offer a new nonpostal service, to take into account, "(A) the public need for the service; and (B) the ability of the private sector to meet the public need for the service." Further, any nonpostal service should primarily utilize existing Postal Service assets to minimize risk. If the Commission finds that the new nonpostal service meets these statutory tests, the Postal Service should be allowed to offer the service. If it does not meet these tests, the Postal Service could not offer the new, nonpostal service.

The same type of regulatory oversight should be applied to any new, nonpostal services as are currently statutorily required for grandfathered nonpostal services. Specifically, in accordance with section 404(e)(5), the "Postal Regulatory Commission shall designate whether the service shall be regulated under this title [Title 39] as a market dominant product, a competitive product, or an experimental product." The

Commission envisions regulatory oversight for new nonpostal services to be a natural extension of the regulation of grandfathered nonpostal services already legislated by Congress.

If Congress decides to allow the Postal Service to offer new nonpostal services, adding these regulatory review and oversight mechanisms to title 39 for new nonpostal services will help ensure that the Postal Service offers profitable, new nonpostal services and minimizes the likelihood of a repeat of the problems of nonpostal service offerings in the late 1990s and early 2000s when the Commission had no regulatory review or oversight of nonpostal services was nonexistent.

#### 4. NSAs and Special Classifications

##### a. Introduction and Summary

The PAEA provided specific legal authority for the Postal Service to create special classifications for mailers, including NSAs. This has resulted in improved pricing flexibility for the Postal Service and an easily accessible, streamlined regulatory process. Since the passage of the PAEA through November 2010, the Commission has reviewed 242 market dominant and competitive NSAs with an average review time of 19 days.<sup>50</sup> The Commission continues to see the potential benefits to the Postal Service and the mailing community of both competitive and market dominant NSAs, and other special classifications.

Below, the Commission traces the pre-PAEA requirements for the NSAs and special classifications process. Then, it discusses how the PAEA changed the landscape with respect to the review process for NSAs and special classifications.

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<sup>50</sup> In many instances, especially early on, the Commission effectively stayed NSA proceedings pending the Postal Service's filing of supplemental information to allow the Commission to complete its regulatory review. Had the Commission dismissed those proceedings and required the Postal Service to refile with complete information, the Commission's average review time would be even lower.

Finally, the Commission focuses on its experience with the NSAs and special classification processes. No legislative changes with respect to NSAs and special classifications are needed.

b. NSAs before the PAEA

The PRA provided the Commission with authority to issue recommended decisions to the Postal Service with respect to price adjustments after a thorough examination of an evidentiary record. While the PRA did not include a specific mechanism for the Postal Service to request NSAs applicable to a single mailer, the Commission found that the factors of the PRA encouraged such agreements. As a result, the Commission adopted regulations governing procedures for reviewing NSAs.

The Commission provided its first recommended decision on an NSA pursuant to “the factors set forth in Title 39 section 3622 (b)” on May 15, 2003. PRC Op. MC2002-2 at 173. Under the PRA, the Commission reviewed a total of nine agreements.<sup>51</sup> There was a consensus among stakeholders that the standard regulatory process used to evaluate NSAs under the PRA was unnecessarily complex and time consuming. Representatives of both the Postal Service and mailers who agreed to a contract were required by statute to engage in a formal proceeding pursuant to the Administrative Procedure Act to justify the agreement. Given these requirements in addition to the initial negotiation effort, the expense and time consuming nature of the NSA process was cited as having a “chilling” effect on such agreements.<sup>52</sup>

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<sup>51</sup> One agreement was withdrawn prior to a final Commission decision. See Docket No. MC2006-3, United States Postal Service Notice of Withdrawal of Request for A Recommended Decision on Negotiated Service Agreement with Washington Mutual Bank, December 8, 2006.

<sup>52</sup> PRC Docket No. RM2007-1, Discover Financial Services Comments, September 24, 2007, at 2-3.

c. PAEA Changes to NSAs

In contrast to the PRA, the PAEA specifically required the Postal Regulatory Commission to establish rules for reviewing special classifications and rates not of general applicability for both market dominant and competitive products. For market dominant products, the statute required the Commission's rules to take into account, as a factor, the desirability of special classifications, including agreements with postal users. The statute also required the Commission to draft rules that would allow it to complete its review of market dominant price adjustments within 45 days. The PAEA envisioned that as part of those rules, market dominant special classifications and agreements with postal users would be allowed so long as the agreements are found to "enhance the performance of mail preparation, processing, transportation, or other functions," "do not cause unreasonable harm to the marketplace," and are available to similarly situated mailers.<sup>53</sup> 39 U.S.C. 3622(c)(10). For competitive products, the PAEA requires the Commission to draft rules that generally allow for competitive agreements not of general applicability as long as the agreements cover their attributable costs at the product level. 39 U.S.C. 3633(a)(2).

d. Commission Experience with the NSA Process Under the PAEA

As directed by the PAEA, the Commission issued final regulations that provide streamlined procedures for reviewing competitive and market dominant NSAs. To ensure the Postal Service was provided maximum flexibility as soon as possible, the Commission promulgated these implementing regulations for the review of NSAs well in advance of the PAEA's deadline.

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<sup>53</sup> The requirement that NSAs and special classifications be made available to similarly situated mailers became the subject of a complaint wherein Capital One Services, Inc. asserted, *inter alia*, that it was similarly situated to Bank of America Corporation, and thus entitled to the same or similar terms as the Bank of America NSA. See Docket No. C2008-3. The complaint was subsequently withdrawn at the request of Capital One as the result of a settlement with the Postal Service.

These rules require the Postal Service to provide sufficient information to allow the Commission to review NSAs for consistency with applicable statutory requirements and carefully balance the PAEA goal of increased transparency and accountability with a streamlined process that provides appropriate due process. Additionally, the Commission thoroughly reviews all proposed NSAs and special classifications for compliance with regulatory and statutory criteria on an annual basis in its Annual Compliance Determination.

The enactment of the PAEA, as well as the Commission's implementing regulations, have created a new, streamlined regulatory process for NSAs and special classifications. New Commission procedures reduced the need for testimony from the Postal Service's NSA partners or for their active participation in the Commission's review process. Accordingly, the Commission review process no longer requires mailers to allocate additional time or financial resources beyond their negotiations with the Postal Service.

Ninety-nine percent of the NSAs reviewed by the Commission pursuant to the requirements of the PAEA have been agreements for competitive products.<sup>54</sup> As of July 2011, the Postal Service has proposed over 250 competitive NSAs under the PAEA. The Commission has reviewed these agreements in an average of 19 days. While most of these cases require analysis of Postal Service costs and mailer profiles, the Commission has demonstrated that it can quickly and efficiently analyze this costing data and provide appropriate oversight that both ensures the Postal Service's ability to compete in the marketplace and prevents cross-subsidization consistent with the PAEA requirements.

To expedite and simplify the review of competitive NSAs, the Commission developed a Global Expedited Package Services (GEPS) "umbrella" contract. See

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<sup>54</sup> See Negotiated Service Agreements Statistics, November 30, 2010.

Docket Nos. MC2011-15 and CP2011-51. This has significantly facilitated the review process while maintaining an appropriate level of oversight. The Postal Service has proposed many GEPS contracts and worked with the Commission to create a framework that allows the Postal Service to enter into certain agreements that do not require pre-implementation review. The Postal Service proposed, and the Commission reviewed and approved, a framework where the Postal Service can enter into agreements with mailers to provide shipping solutions within a certain pricing framework. Commission review found that all of the prices within the framework's parameters should cover their costs and be consistent with the requirements of the PAEA. This "umbrella" allows the Postal Service considerable pricing flexibility for these products while reducing the regulatory burden on each contract. At the same time, it ensures valuable oversight and transparency. The success of this pricing framework highlights the pricing flexibility entrusted to the Postal Service under the PAEA and the ability of the Commission to streamline regulatory oversight where opportunities for improvement arise.

The Postal Service has successfully utilized the streamlined process to design and implement many competitive NSAs; however, it has only proposed one domestic market dominant NSA since the passage of the PAEA. The Commission approved this agreement with Discover Financial Services, which was designed to maintain and encourage additional net revenue generated by the mailer.<sup>55</sup> The Postal Service's strategy for utilizing pricing flexibility for market dominant products has instead focused on the development of special classifications. The Postal Service has proposed and implemented six market dominant special classifications, most of which were short-term seasonal programs designed to encourage increased use of the mail through volume-based discount incentives. They shared common characteristics with NSAs, in that they included mailer-specific thresholds that each participant had to achieve to qualify for

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<sup>55</sup> See Docket No. R2011-3, Order No. 694, Order Adding Discover Financial Services 1 Negotiated Service Agreement to the Market Dominant Product List, March 15, 2011.

discounts. Unlike previous market dominant NSAs, these programs were made available to a broad group of mailers and the thresholds were determined by formulae, rather than being negotiated individually with each mailer.

e. Commission Recommendations for Legislative Change

The streamlined oversight provided by the Commission plays an important role in ensuring that the Postal Service is using accurate information in reaching agreements with mailers. The Commission experience with the GEPS umbrella contract shows that much of the past regulatory burden to mailers can be significantly reduced, if not altogether eliminated.

Experience with the review process of market dominant and competitive NSAs, thus far, has been positive. While mailers have expressed concerns about the time and expense associated with NSAs, these concerns include the time and expense associated with negotiating and designing NSAs with the Postal Service. Experience suggests that the time and effort required to put an NSA into effect is due, in greater part, to negotiating with the Postal Service and internal Postal Service review and approval rather than to the Commission's limited regulatory review.

There is significant potential for the umbrella-type pricing innovation with respect to other types of competitive NSAs as well as market dominant NSAs. Properly designed NSAs, both market dominant and competitive, offer potential benefits to the Postal Service and to mailers. The Commission encourages the Postal Service to fully utilize this pricing flexibility.

5. Service Performance Measurements and Customer Satisfaction

a. Introduction

A significant change required by the PAEA is the addition of service performance standards for market dominant products and reporting of service performance. The

PAEA tasked the Postal Service with establishing modern service standards and performance goals for each of its market dominant products. The service performance of each market dominant product is to be measured and its performance reported to the Commission in the Postal Service's ACR. This information is then reviewed by the Commission in the ACD. As part of this effort, the Postal Service also is to report the degree of customer satisfaction with each market dominant product.

This section begins with a review of service performance and customer satisfaction requirements that predate the PAEA. Next, each step of the four-step process that the Postal Service and the Commission have undertaken to implement the PAEA requirements is examined. These steps include establishing modern service standards, identifying service performance measurement systems, establishing performance goals, and establishing reporting requirements. Also, this section discusses the Commission's frequent review of the Postal Service's implementation of service performance measurement systems. Finally, this section discusses one potential legislative clarification regarding changes in service standards. Specifically, to eliminate possible confusion, Congress should consider clarifying the law to ensure that consultations with the Commission are required for proposals to change service standards.

b. Pre-PAEA Service Performance and Measurement

Prior to the PAEA, the Postal Service was not required to measure or report on service performance for any of its products. The Postal Service predominantly measured service performance as part of its internal diagnostics to evaluate its network. Results of these measurements were not publicly disseminated, except for the

performance of single-piece First-Class Mail measured using the External First-Class measurement system (EXFC).<sup>56</sup>

Although there were no service performance measurement requirements, service performance played an important role under the pre-PAEA legislation. Most importantly, pre-PAEA service performance was considered under the factors for setting rates and determining mail classifications.

The PAEA placed a new emphasis on service performance. The Commission was tasked with reviewing the Postal Service's quality of service for all market dominant products, including speed of delivery, reliability, and the level of customer satisfaction. The review is undertaken to ensure that quality of service does not deteriorate under the CPI price cap system because of the potential to cut costs by way of service reductions to comply with price cap requirements. This rationale is in addition to the needs of the Postal Service to understand the service performance of its products, and the transparency that such reporting provides to mailers.

c. Modern Service Standards Under the PAEA

Section 3691(a) of title 39 specifies that "[n]ot later than 12 months after the date of enactment of this section, the Postal Service shall, in consultation with the Postal Regulatory Commission, by regulation establish (and may from time to time thereafter by regulation revise) a set of service standards for market-dominant products."

Initial consultations between the Commission and the Postal Service concluded on November 19, 2007 with the Commission providing the Postal Service with comments addressing the Postal Service's service standards proposals. The Postal Service completed this task by publishing as a final rule Modern Service Standards for

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<sup>56</sup> From time to time, the Postal Service experimented with other measurement systems, but EXFC was the only measurement system consistently used for which the results were publically disseminated.

Market Dominant Products, December 19, 2007 (Service Standards). See 72 FR 72216 (December 19, 2007).

d. Service Performance Reporting Under the PAEA

Section 3652(a)(2) of title 39 requires the Postal Service to include in an annual report to the Commission an analysis of the quality of service “for each market-dominant product provided in such year” by providing “(B) measures of the quality of service afforded by the Postal Service in connection with such product, including—(i) the level of service (described in terms of speed of delivery and reliability) provided; and (ii) the degree of customer satisfaction with the service provided.” In complying with this requirement, the Commission has authority to “by regulation, prescribe the content and form of the public reports (and any nonpublic annex and supporting matter relating to the report) to be provided by the Postal Service....” 39 U.S.C. 3652(e)(1). The Commission also has the authority to initiate proceedings to improve the quality, accuracy and completeness of data whenever it appears that “the quality of service data has become significantly inaccurate or can be significantly improved.” 39 U.S.C. 3652(e)(2)(B). In addition, the Commission has access to “supporting matter” in connection with any information submitted under this section. 39 U.S.C. 3652(d).

Section 3622 of title 39 provides that the Commission by regulation establish “a modern system for regulating rates and classes for market-dominant products.” 39 U.S.C. 3622(a). The quality of service and its reporting forms an integral part of many of the objectives and factors set forth in this section. Reporting on quality of service allows assessment of whether the Postal Service is meeting the objective of maintaining the “high quality service standards established under section 3691.” 39 U.S.C. 3622(b)(3). It furthers the objective of increasing “the transparency of the ratemaking process.” 39 U.S.C. 3622(b)(6). It allows assessment of the factors addressing value of service, and by association with the proposed measurement systems, the value of Intelligent Mail. 39 U.S.C. 3622(c)(1), (8), and (13). Finally, it is

important in relation to the rate cap requirements of 39 U.S.C. 3622(d)(1)(A) when analyzing whether quality of service is impacted in order to comply with rate cap requirements.

Section 3651(b)(1)(A) of title 39 requires that the Commission report to the President and Congress on an annual basis estimates of the costs incurred by the Postal Service in providing universal service. Describing the quality of service afforded a product, both anticipated and actual, is a necessary element in analyzing what service is being provided at a given cost. The Postal Service is to provide the Commission with such information that may, in the judgment of the Commission, be necessary in completing this report. 39 U.S.C. 3651(c).

On September 2, 2009, the Commission established Docket No. RM2009-11 to consider the addition of service performance and customer satisfaction reporting requirements to the Commission's rules of practice and procedure. Final rules were issued on May 25, 2010, specifying Postal Service reporting requirements for measuring the level of service and degree of customer satisfaction for each market dominant product.

e. Service Performance and Measurement Systems Under the PAEA

The Postal Service is guided by objectives (39 U.S.C. 3691(b)) and factors (39 U.S.C. 3691(c)) when establishing service standards. One objective requires the establishment of a "system of objective external performance measurements for each market-dominant product..." 39 U.S.C. 3691(b)(1)(D). However, "with the approval of the Postal Regulatory Commission an internal measurement system may be implemented instead of an external measurement system." 39 U.S.C. 3691(b)(2).

In June 2008, the Postal Service identified service performance measurement systems by providing the Commission with a draft of its Service Performance Measurement Plan (Plan). The Plan presents the various systems the Postal Service

proposes to use to measure the standards presented in the Service Standards document. The Postal Service submitted the Plan for the Commission's "review, feedback, and concurrence."<sup>57</sup> In response, the Commission initiated Docket No. PI2008-1 to solicit public comment and consider the Plan. This process culminated with Commission Order No. 140, approving the approaches that the Postal Service proposed to take in developing internal measurement systems for various classes of mail.<sup>58</sup> Most notably, the Commission granted a Postal Service request to proceed with development of an internal hybrid measurement system based on Intelligent Mail barcodes (IMb) to measure service performance for many of its products.

The Postal Service took a variety of approaches to measure the service performance of various market dominant products. The single-piece components of First-Class Mail Single-Piece Letters/Postcards and Flats use the EXFC measurement system.<sup>59</sup> The bulk components of First-Class Mail Letters/Postcards and letter- and card-shaped Standard Mail use an IMb hybrid measurement system.<sup>60</sup> Parcel-shaped mail uses a Delivery Confirmation-based system.<sup>61</sup> International Mail uses an

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<sup>57</sup> Letter from Thomas G. Day, Senior Vice President, United States Postal Service, to Dan G. Blair, Chairman, Postal Regulatory Commission, June 3, 2008.

<sup>58</sup> See Docket No. PI2008-1, Order Concerning Proposals for Internal Service Standards Measurement System (Order No. 140).

<sup>59</sup> EXFC is an external measurement system utilizing contractors to seed the mail and measure the time it takes from deposit of mail into a collection box or lobby chute until its delivery to a home or business. EXFC continuously tests service in 892 three-digit ZIP Code areas between which most Single-Piece First-Class Mail originates and destines.

<sup>60</sup> This hybrid measurement system relies upon IMb data to measure the time from mail acceptance through the last processing scan combined with external reporters recording in home delivery to develop end-to-end service performance measurements.

<sup>61</sup> This system measures transit time from the time of mailing until the time of delivery for those parcels that a customer requested Delivery Confirmation service.

International Mail Measurement System (IMMS).<sup>62</sup> Periodicals Mail uses Red Tag and Del-Trak-based systems.<sup>63</sup> Finally, Special Services use measurement systems unique to the service being measured. To date, EXFC and IMMS are the only systems that are fully operational and considered reliable. The Commission continues to monitor the development of the other systems.

The Postal Service also has developed internal systems for the measurement and reporting of customer satisfaction. Customer satisfaction is examined under two broad categories, customer experience and access to postal services. The Postal Service has implemented a Customer Experience Measurement system, which uses customer survey instruments for measuring and reporting on customer experience. The Postal Service measures customer access by reporting on changes in the number of post offices, residential and business delivery points, and collection boxes. Also, average customer wait time in line for retail services is reported.

f. Performance Goals for Service Standards Under the PAEA

The Postal Service, in consultation with the Commission, also is to develop and submit to Congress a plan for meeting its service standards. See PAEA section 302. This plan is to include the establishment of performance goals. The Postal Service submitted its section 302 Plan on June 19, 2008. The Postal Service posted its current FY 2011 targets on its website accessible by mailers.

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<sup>62</sup> IMMS is an external measurement system relying on contractors to seed International Mail and develop end-to-end service performance measurements. The Postal Service only reports the domestic travel time within the United States developed from IMMS data.

<sup>63</sup> The Red Tag Monitoring Service is operated by the not-for-profit Red Tag News Publications Association to monitor service for association members. The Del-Trak System is operated by Time, Inc. to monitor service for several of its publications. Service is measured end-to-end using mailer reported entry times to start-the-clock and external reporter delivery dates.

g. Current Status of Service Performance

The Commission required the Postal Service to follow a two-step process to achieve full compliance with all reporting requirements by the filing date of the FY 2011 ACR.<sup>64</sup> The first step allowed the Postal Service to seek semi-permanent exceptions from service performance reporting as allowed by 39 CFR 3055.3. The Postal Service sought and was granted multiple semi-permanent exceptions, predominantly in the areas of Special Services and NSAs. The second step allowed the Postal Service to seek waivers from reporting where more time is needed to fully develop service performance measurement systems. The Postal Service sought waivers for the majority of market dominant products requiring measurement, including all products that use IMb-based measurement systems.

The IMb measurement system and associated electronic documentation perform a critical role in measuring service performance for the majority of mail. However, significant issues continue to hinder the IMb system from realizing its full potential as a reliable and comprehensive component of service performance measurement. The Postal Service has reported problems with data yield, which is the percentage of usable data that may be obtained from IMb measurements. Related problems also have been reported with obtaining an accurate “start-the-clock” time, which is the starting time for all service performance measurements. Furthermore, the current documentation required by the IMb-based measurement system is not sufficient to support reporting Standard Mail by product as required by the PAEA. This is especially problematic for products that are not covering their costs.<sup>65</sup>

In the interim, the Postal Service reports service performance with data that it believes are reliable. The insight these data provide into service performance is

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<sup>64</sup> See Docket No. RM2009-11, Order Establishing Final Rules Concerning Periodic Reporting of Service Performance Measurements and Customer Satisfaction, May 25, 2011 (Order No. 465).

<sup>65</sup> See, e.g., Standard Mail Flats, discussed *supra*.

valuable, but a significant effort is still required on the part of the Postal Service to provide data in compliance with the PAEA and the Commission's reporting requirements.

Standard Mail users have expressed frustration with Postal Service decisions to regularly seek waivers from the Commission for reporting service performance of Standard Mail products. In order for the PAEA's modern system of rate regulation to work as intended, the Postal Service must effectively measure service performance for its postal products. Effective service performance measurement would become even more important if Congress were to enact the Commission's proposal regarding service rate adjustments. See *supra* chapter IV.C.1.e.

#### h. Commission Recommendations

As proposed by the Postal Service and adopted by the Commission, the Postal Service is to provide detailed quarterly service performance reports that can be used to thoroughly analyze service performance, in addition to aggregated annual reports that more appropriately meet the needs of the ACD. Without the transparency provided through quarterly reports, the Commission would find it difficult if not impossible to fully analyze service performance. To date, the Postal Service is attempting to provide this information and, if the need arises, the PAEA has provided the Commission with sufficient tools to ensure that the Postal Service fulfills the PAEA's service performance and measurement requirements.

The Commission recommends that Congress consider clarifying the current statutory language regarding changes to service standards. The law clearly requires the Postal Service to consult with the Commission in establishing service standards for market dominant products. 39 U.S.C. 3691(a). However, the law does not directly address whether changes in service standards require such consultation. The Commission finds that section 3691 requires the Postal Service to engage in such consultations. Notwithstanding, some stakeholders have argued that such a

consultation is not statutorily required. To eliminate potential confusion, Congress should consider clarifying the law to ensure that similar consultations with the Commission are required for proposals to change service standards. Additionally, the Commission's proposal for service price adjustments, as further discussed in chapter IV.C.1., provides an incentive for the Postal Service to improve its service performance. Successful implementation of that proposal will require regular review and oversight of service performance as suggested in this section.

## 6. Market Tests of Experimental Products

### a. Introduction and Summary

In this section, the Commission discusses the statutory and regulatory authority governing market tests of experimental products.

The PAEA provides the Postal Service with the authority to conduct market tests of experimental postal products. See 39 U.S.C. 3641. Provisions such as 39 U.S.C. 3641 enable the Postal Service to create innovative postal products and services in order to adapt to changing customer needs as well as information and communication technologies.

Since the passage of the PAEA, the Postal Service has filed six market tests of experimental products with the Commission. The Commission has expeditiously reviewed and approved all of the six market tests. The Commission has worked cooperatively and successfully with the Postal Service, mailers, and other stakeholders in the postal community to determine whether the Postal Service should pursue a particular market test of an experimental product. The current law is working effectively with respect to market tests. Nonetheless, to encourage the Postal Service to innovate on a larger scale, the Commission recommends that Congress consider amending the statute to allow the Postal Service to experiment with larger market tests.

b. New Product Experiments Pre-PAEA

The PRA of 1970 provided the Postal Service with broad authority to test and introduce new postal and nonpostal products. New domestic postal products were subject to a Postal Rate Commission recommended decision and special Postal Rate Commission rules for expedited review of market tests. *See former* 39 U.S.C. 3623; *former* 39 CFR 3001.161 *et seq.* The Postal Service also had the authority “to provide, establish, change, or abolish special nonpostal or similar services[.]” *See former* 39 U.S.C. 404(a)(6). The PRA, however, did not require the Postal Service to request a recommended decision from the Commission before offering new nonpostal products, such as telephone cards and retail merchandise.<sup>66</sup>

The Postal Service developed and marketed a number of new postal and nonpostal products prior to the PAEA. Some examples of the products that were developed and marketed during that period include the Firstclass Phone Card, Remitco, Electronic Commerce Services, Global Priority Mail, Global Package Link, Retail Merchandise, PostOffice Online, WEB Interactive Network of Government Services, Deliver America, Information Based Indicia Program, Customer-Initiated Payment System, Unisite Antenna Program, LibertyCash, Sure Money, and Global e-Post. 1998 GAO Report, Appendix III.

Two main concerns arose out of the market tests conducted under the PRA. First, the Postal Service lacked sufficient flexibility to innovate and offer new products and services. S. Rep. No. 108-318 (July 22, 2008) at 16. The PRA required the Postal Service to request a recommended decision from the Commission before offering any new domestic postal product or service. *See id.* Although the Commission established

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<sup>66</sup> General Accounting Office (GAO), U.S. Postal Service—Development and Inventory of New Products, Report to the Chairman, Subcommittee on the Postal Service, Committee on Government Reform and Oversight House of Representatives, November 1998, requested by Congressman John M. McHugh, Chairman, Subcommittee on the Postal Service, Committee on Government Reform and Oversight, at 10 (1998 GAO Report).

rules expediting review of experimental and market test classification requests, the Postal Service and other stakeholders observed that the Postal Service needed more flexibility to facilitate an entrepreneurial approach to product development. *Id.*

Second, the Postal Service's introduction of new products stirred controversy among stakeholders in the postal community. Many of the new products developed were not successful. For example, during the first three quarters of FY 1998, only 4 of the 19 new products introduced by the Postal Service covered their cost. 1998 GAO Report at 4. The new products in the area of electronic commerce were especially unsuccessful.<sup>67</sup>

In particular, stakeholders were concerned about the Postal Service's new nonpostal products. Some members of Congress and some private sector companies believed that the Postal Service was unfairly expanding its product line to compete in nonpostal-related markets. 1998 GAO Report at 5. They argued that the Postal Service, as a governmental entity, would have an unfair advantage when introducing products that compete with private sector companies. *Id.* at 1, 32.

#### c. Market Tests Under the PAEA

Congress addressed the concerns about new nonpostal products and the Postal Service's lack of flexibility in the PAEA. Like the PRA, the PAEA provides the Postal Service with the authority to conduct market tests of experimental products. See 39 U.S.C. 3641. However, the PAEA restricts the Postal Service from engaging in market tests of new nonpostal services. In general, the PAEA prohibits the Postal Service from offering new nonpostal services. *Id.* 404(e)(2). This restriction also appears in section 3641, which authorizes the Postal Service to "conduct market tests

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<sup>67</sup> General Accounting Office (GAO), US Postal Service—Update on E-Commerce Activities and Privacy Protection, Report to the Ranking Member, Subcommittee on International Security, Proliferation, and Federal Services, Committee on Government Affairs, U.S. Senate, December 2001; *see also* President's Commission on the United States Postal Service, Embracing the Future Report at ix and 27.

of experimental *products*.” *Id.* 3641(a)(1) (emphasis added). Products must, by definition, be postal services. *Id.* 102(6). The statutory prohibition on new nonpostal services is also supported by the legislative history, which states that the PAEA “limits the scope of the Postal Service’s product offerings to ‘postal products[.]’” S. Rep. No. 108-318 (July 22, 2004) at 16.

Aside from the restriction on new nonpostal services, the PAEA gives the Postal Service much more flexibility to introduce new products and services. The Postal Service has streamlined authority to introduce experimental products, allowing the Postal Service to innovate and do what is necessary to make the products offered valuable to customers. *Id.* at 23. To ensure that proper safeguards exist to protect both customers and competitors of the Postal Service, *see id.* at 16-17, the PAEA specifies certain requirements. At least 30 days before initiating a market test, the Postal Service must file with the Commission and publish a *Federal Register* notice describing the test’s nature and scope and setting out the basis of its determination that the market test meets the requirements of section 3641. 39 U.S.C. 3641(c)(1). The test must also meet the following conditions:

- The product tested must be significantly different, from the viewpoint of the mail users, from all products offered by the Postal Service within the past two years;
- The introduction or continued offering of the product will not create an unfair competitive advantage for the Postal Service or any other mailer; and
- The product must be correctly classified either as market dominant or competitive.

*Id.* 3641(b).

The market test period may not exceed 24 months unless the Commission grants an extension of the test period for up to an additional 12 months. *Id.* 3641(d). In general, anticipated or received revenues for a market test product may not exceed

\$10 million per year, as adjusted for inflation. *Id.* 3641(e)(1), (g). The Commission may exempt the Postal Service from this limitation as long as anticipated or received revenues do not exceed \$50 million per year, as adjusted for inflation, and the test meets other applicable requirements. *Id.* 3641(e)(2), (g). If the Commission determines that a market test fails to meet any requirement under section 3641, it may cancel the test or take other action as it deems appropriate. *Id.* 3641(f).

d. Commission Experience with Market Tests Under the PAEA

The Postal Service began to make use of the flexibility afforded by the market test provisions in the PAEA two years after its passage by Congress. Since 2009, it has filed a total of six market tests of experimental products: Docket No. MT2009-1 Collaborative Logistics; Docket No. MT2010-1 Samples Co-op Box; Docket No. MT2011-1 Alternate Postage Payment Method for Greeting Cards; Docket No. MT2011-2 Gift Cards; Docket No. MT2011-3 Marketing Mail Made Easy,<sup>68</sup> and MT2011-4 Mail Works Guarantee.

The Commission has reviewed and approved all six market tests and has granted a temporary extension of the Collaborative Logistics market test to the Postal Service. As part of its review process, the Commission considers comments and opinions from interested persons, mailers, and other stakeholders in the postal community. The Commission also reviews public comments and Postal Service responses to information requests issued by the Chairman of the Commission.

The law allows the Postal Service to create innovative new products in response to changing customer mailing habits and needs as well as evolving information and communication technologies. The law also provides appropriate safeguards to protect both customers and competitors of the Postal Service. The Postal Service is just beginning to make use of the market test aspects of the PAEA. It is too early to

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<sup>68</sup> The name of this experimental product was later changed to "Every Door Direct Mail Retail."

evaluate whether or not any particular market test will be successful in the long run. The Postal Service has indicated that it intends to make Collaborative Logistics a permanent offering in the near future; however, the total revenue generated from the Collaborative Logistics market test during the two-year test period was less than \$3 million. It is, therefore, premature to predict the effects of these products on the financial condition of the Postal Service.

Thus far, it appears that the statutory authority and rules governing the market test of experimental products under the PAEA have worked as intended in providing the Postal Service with the appropriate level of flexibility to develop and conduct market tests of new postal products.

e. Commission Recommendations for Legislative Change

To encourage more innovation at the Postal Service, the Commission recommends that Congress consider allowing the Postal Service to experiment with larger market tests by raising the maximum revenue limitation on experimental market test products. This will allow the Postal Service to advance even more ideas that could bolster the Postal Service's revenue streams. The Commission, the Postal Service, and the mailing community have worked cooperatively and successfully to facilitate market tests of experimental products as envisioned by the PAEA. The current law is working effectively. The constraints on market tests have not proven to be unduly burdensome. They strike a reasonable balance between allowing the Postal Service flexibility to experiment with new products while limiting the potential for harm to private sector competitors from encroachment by the Postal Service.

## D. Enhancements to Improve the Commission's Processes

### 1. Post Office Closing Procedures

#### a. Introduction and Summary

The statutory procedures provide the public with appropriate procedural notice and an opportunity for comment. As discussed below, the Commission has set statutory criteria for post office closing appeals. In the interest of furthering the PAEA goals of transparency and accountability, the Commission recommends that Congress consider requiring the Postal Service to provide regular reports to the Commission on its retail network plans and activities. This will ensure that Congress, the public, and the Commission will be informed of the status of the Postal Service's closure and consolidation efforts.

In the discussion that follows, the Commission traces the statutory and regulatory basis for appeals by postal patrons of proposed post office consolidations and closings. Accompanying that discussion is an overview of Commission appeal proceedings both before and after the 2006 enactment of the PAEA and a description of recent Commission proceedings involving the Postal Service's practice of imposing emergency suspensions of post office operations for extended periods. Next, there is a discussion of recent amendments to the Postal Service regulations governing post office consolidations and closings. The regulations have potentially important implications for the Commission's appeals process. Finally, the Commission discusses its Congressional recommendations with respect to the post office closing appeals process.

In particular, Congress should consider requiring the Postal Service to provide regular reports to the Commission on its retail network plans and activities, including identifying all post offices that have been suspended and those where closure actions have been taken. The reports should also contain information on how particular

closings conform with previously filed plans and alternative access. Additionally, while the Commission believes that its longstanding interpretation of the scope of appeals from Postal Service determinations to close or consolidate post offices follows the intent of Congress, the Postal Service disagrees with the Commission's interpretation. Accordingly, to eliminate potential confusion, the Commission recommends that the scope of appellate review from Postal Service determinations to close Postal Service operated retail facilities be clarified and adopt the plain meaning of post office to include all retail offices operated by the Postal Service.

b. Statutes and Regulations

The statutory right of postal patrons to obtain review by the Commission of the consolidation or closure of a post office was originally enacted as part of 1976 amendments to the Postal Reorganization Act, codified as 39 U.S.C. 404(b). Section 404(b) was subsequently redesignated by the PAEA as section 404(d).

Section 404(d)(2) requires the Postal Service, in making a determination whether or not to close or consolidate a post office, to consider: (a) the effect on the community; (b) the effect on the employees; (c) the economic savings to the Postal Service; (d) whether the closing or consolidation would be consistent with postal policy that the Postal Service shall provide a maximum degree of effective and regular postal services to rural areas, communities, and small towns where post offices are not self-sustaining; and (e) such other factors as the Postal Service determines are necessary.

Section 404(d)(5) authorizes persons served by a post office to file an appeal with the Commission within 30 days of a Postal Service determination to close or consolidate their post office. The Commission has 120 days in which to review the Postal Service's determination. That review must be based upon the record on which the Postal Service based its determination. The Commission must set aside any Postal Service determinations, findings, or conclusions that (a) are arbitrary or capricious, an abuse of discretion, or otherwise not in accordance with law; (b) fail to observe

procedures required by law; or (c) are unsupported by substantial record evidence. The Commission can take one of two actions. It can either affirm the Postal Service's determination, or it can return the entire matter to the Postal Service for further consideration.

It is important to note that the Commission cannot modify the Postal Service's determination. However, the Commission can issue an order staying the effectiveness of the Postal Service's determination pending its final decision on the appeal.

The Commission has adopted procedural rules governing Postal Service determinations to close or consolidate post offices. Those rules are contained in subpart H of the Commission's rules of practice. 39 CFR 3001.111 *et seq.* Briefly summarized, the Commission's regulations provide the person appealing the Postal Service determination and other interested persons the opportunity to challenge the basis for the Postal Service's determination to close a post office and the procedures used to reach its decision. In addition to written presentations, the regulations permit appellants to request an opportunity to make an oral presentation to the Commission.

c. Appeals Prior to the PAEA

Between 1976 and 2006, the Commission received over 300 appeals of post office closures or consolidations. Approximately 40 of those appeals resulted in remands to the Postal Service for further consideration based upon findings by the Commission that the Postal Service did not follow these mandatory statutory requirements.

d. Appeals Under the PAEA

Since the enactment of the PAEA in 2006, the Commission has docketed 45 appeal proceedings. A single appeal was filed during each of fiscal years 2007 and 2009. Six appeals were filed during FY 2010. As of the end of July 2011, 37 appeals have been filed during the current FY 2011. Of the 45 post office closing appeals filed

since the enactment of the PAEA until the end of July 2011, 18 appeals were decided in favor of the Postal Service; 1 appeal was remanded for further proceedings because the record upon which the Postal Service based its decision was based on outdated information; 2 appeals are awaiting completion of a Postal Service discontinuance study; and 24 appeals were still pending as of the end of July 2011.

e. Current Issues

Two recurring issues of general applicability have arisen in several of the appeals filed at the Commission.

(1) The Issue of Stations and Branches

The Postal Service and the Commission disagree whether the closure of postal stations and branches is covered by the appeal provisions of section 404(d)(5). The Postal Service has taken the position that as used in section 404(d)(5), the term “post office” applies only to a postal facility that constitutes “an organizational unit headed by a postmaster that provides retail and delivery services, and mail processing, to residents and businesses in the ZIP Code areas that comprise that office’s exclusive delivery service area.”<sup>69</sup> By contrast, the Commission’s longstanding position is that Congress intended the term “post office” in section 404(d)(5) to be interpreted “in its ordinary sense—*i.e.*, a fixed retail facility serving the public and acting as the point of origin for delivery routes....” *In re Gresham, SC*, Order No. 208, August 16, 1978, at 6-7.<sup>70</sup> On the basis of that interpretation, the Commission maintains that the term “post

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<sup>69</sup> See 76 FR 41413 (July 14, 2011); see also *Post Office Organization and Administration: Establishment, Classification and Discontinuance*, 76 FR 17794 (proposed March 31, 2011).

<sup>70</sup> The Commission’s continued adherence to this broader definition was restated shortly before passage of the PAEA and has been reiterated following the PAEA’s enactment. See Docket No. A2006-1, Order Denying Postal Service Motion to Dismiss and Remanding for Further Consideration, September 29, 2006, at 5-12; see also Docket No. N2009-1, Advisory Opinion Concerning the Process for Evaluating Closing Stations and Branches, March 10, 2010, at 61, 66.

office” includes not only postal facilities covered by the Postal Service’s organizational unit definition, but postal stations and branches, as well.

## (2) The Issue of Emergency Suspensions

A second recurring issue of general applicability involves the Postal Service’s use of emergency suspensions. The Postal Service defines an “emergency suspension” as “an occurrence that constitutes a threat to the safety and health of Postal Service employees or customers or to the security of mail or revenue.”<sup>71</sup> Among the circumstances which may justify an emergency suspension are natural disasters, lease terminations, lack of qualified personnel, severe health or safety hazards, and other similarly serious situations. *Id.*

After this issue was brought to light in another proceeding,<sup>72</sup> the Commission instituted a public inquiry to investigate what appeared to be a Postal Service practice of “avoiding...[the discontinuance]...process by suspending post offices and allowing them to simply remain suspended without any action.”<sup>73</sup> While no specific action was taken as a result of the public inquiry docket, it has brought the issue to the attention of the Postal Service and the general public. As a result of the Commission’s increased transparency and accountability of the Postal Service on this issue, the Postal Service now appears to be monitoring the practice of its local officials to ensure that the

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<sup>71</sup> Post Office Discontinuance Guide, Handbook PO-101 (August 2004) (Handbook) at section 611.

<sup>72</sup> Docket No. A2009-1, Order on Appeal of Hacker Valley, West Virginia Post Office Closing, October 19, 2009. In *Hacker Valley*, it was suggested by several participants that the Postal Service might be using an emergency suspension as a *de facto* post office discontinuance. In its order, the Commission announced its intent to initiate a public inquiry in order to develop a more complete record on emergency suspensions and stated that the public inquiry would facilitate fulfillment of its responsibility to submit reports under the PAEA section 701 recommending legislation to improve the effectiveness of postal laws.

<sup>73</sup> Docket No. PI2010-1, Notice and Order Providing an Opportunity to Comment, November 9, 2009, at 3 (Order No. 335).

emergency suspension process is being used only as intended and that facilities that were previously suspended on a seemingly indefinite basis are reviewed in a timely manner for potential closure or other appropriate action.<sup>74</sup>

f. The Postal Service's Rulemaking

On March 28, 2011, the Postal Service transmitted a letter to the Commission explaining proposed changes to its regulations in 39 CFR part 241 intended "to improve the administration of the Post Office closing and consolidation process" and to apply "certain procedures employed for the discontinuance of Post Offices to...the discontinuance of other types of retail facilities operated by Postal Service employees."<sup>75</sup> On May 2, 2011, the Commission submitted written comments that address a number of matters, including subjects with potential implications for the appeals process authorized by section 404(d)(5).<sup>76</sup> On July 14, 2011, the Postal Service published its final rules altering these regulations.<sup>77</sup> The Postal Service's final rules adopted many of the Commission's suggestions with the notable exception of notification of potential appeal rights to postal patrons for discontinuance decisions involving a post office station or post office branch.

These regulatory changes proposed by the Postal Service are also the subject of a complaint filed with the Commission by the National Association of Postmasters of the

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<sup>74</sup> Extensive information regarding emergency suspensions has been collected from the Postal Service and the public in the public inquiry instituted by Order No. 335.

<sup>75</sup> Letter from Mary Anne Gibbons, General Counsel, United States Postal Service to Stephen Sharfman, General Counsel, Postal Regulatory Commission, March 28, 2011. The proposed regulatory changes were subsequently published in the *Federal Register*. See also Post Office Organization and Administration: Establishment, Classification and Discontinuance, 76 FR 17794 (proposed March 31, 2011).

<sup>76</sup> Comments of the United States Postal Regulatory Commission, 39 CFR Part 241, *Proposed Amendments to Post Office Consolidations and Closing Process*, May 2, 2011.

<sup>77</sup> 76 FR 41413 (July 14, 2011).

United States, the League of Postmasters, and certain individuals in their capacities as association officers, postmasters or retired postmasters, and postal customers.<sup>78</sup> Among the allegations set forth in the complaint are claims that the Postal Service's proposed regulatory changes are inconsistent with section 404(d)(5). *Id.*

g. Commission Recommendations

The Commission finds that the statutory procedural requirements for closing post offices under 39 U.S.C. 404(d) do not require changes at this time. They provide members of the public with appropriate procedural notice and an opportunity to have their views heard by the Postal Service in connection with potential discontinuance actions. They also ensure that the Postal Service follows these statutory procedural requirements in the form of an independent check and balance on the Postal Service closing decisions by allowing appellate review to the Commission.

However, in the interest of furthering the PAEA goals of transparency and accountability, Congress should consider requiring the Postal Service to provide regular reports to the Commission on the Postal Service's plans and activities regarding its retail network, including identifying all post offices that have been suspended and those where closure actions have been taken. The reports should also contain information on how particular closings conform with previously filed plans and alternative access.

The Commission recognizes that the Postal Service is currently in the process of realigning its retail network. Regularly reporting to the Commission on its plans and activities in this area would ensure that Congress, the public, and the Commission will be better informed of the status of the Postal Service's retail network closure and

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<sup>78</sup> Docket No. C2011-3, Complaint of the National Association of Postmasters of the United States, the League of Postmasters, Mark Strong, Robert Rapoza, Marilyn Shaw, and Marilyn Hill, May 23, 2011.

consolidation efforts. This will further the PAEA goals of transparency and accountability.

The Postal Regulatory Commission and its predecessor agency, the Postal Rate Commission, have a long-established interpretation for the term “post office” as used in 39 U.S.C. 404(d). Since the late 1970s, the Commission has repeatedly found that the term is used in the ordinary sense of the word, as a postal retail facility serving the public. The Postal Service disagrees with this interpretation. This creates uncertainty and confusion among citizens. To eliminate this uncertainty and confusion and for the benefit of postal customers, the Commission recommends that the scope of the Commission’s appellate review of determinations to close postal operated retail facilities be clarified to adopt the plain meaning of the term post office which would include stations and branches.

## 2. Advisory Opinion Process

### a. Introduction and Summary

The advisory opinion process created in title 39, section 3661 provides sound and beneficial advice for the Postal Service to use when it is considering nationwide or substantially nationwide changes in service. It also provides an expert, unbiased analysis of major issues to Congress and the American public. However, a few minor changes in the statute may improve the advisory opinion process.

Below, the Commission traces the current statutory and regulatory requirements for the advisory opinion process. Then, it discusses the historical use of the advisory opinion process both pre- and post-PAEA. Next, the Commission focuses on its experience with the advisory opinion process. Finally, based on that experience, the Commission provides its recommendations for legislative change with respect to the advisory opinion process. Specifically, Congress should allow the Postal Service to obtain expedited consideration from the Commission for time-sensitive requests for

advisory opinions on proposals to change service on a nationwide or substantially nationwide basis. Additionally, Congress should consider adding language to 39 U.S.C. 3661 requiring the Postal Service to provide a written response to Commission advisory opinions.

b. Statutory and Regulatory Requirements

The PRA provided a mechanism for the Postal Service to request that the Postal Rate Commission issue a non-binding advisory opinion whenever the Postal Service determines it should make a “change in the nature of postal services affecting service on a nationwide or substantially nationwide basis.” 39 U.S.C. 3661(b). Commission regulations currently require such requests to be submitted “not less than 90 days” before such change is scheduled to take effect. 39 CFR 3001.72.

The law requires the Commission to conduct a court-like evidentiary hearing on the record in accordance with the formal adjudication requirements of the Administrative Procedure Act. See 39 U.S.C. 3661(c); 5 U.S.C. 554. The Commission must allow the Postal Service, the users of the mail, and an officer of the Commission appointed to represent the interests of the general public (Public Representative) to participate in the proceeding. 39 U.S.C. 3661(c). After the hearing is completed, the Commission must provide its advisory opinion in writing and include a certification of each Commissioner agreeing with the opinion that it “conforms to the policies established under” title 39. *Id.*

c. Background on the Use of the Advisory Opinion Process

Prior to the passage of the PAEA, the Postal Service requested a total of five advisory opinions from the Postal Rate Commission since 1971. These cases were as follows:

- PRC Docket No. N75-1—Review of a Postal Service program that adopted market analysis techniques for the location and staffing of postal retail facilities.

- PRC Docket No. N75-2—Review of a Postal Service initiative to combine First-Class Mail and Airmail Service.
- PRC Docket No. N86-1—Review of a Postal Service initiative to allow COD payments to be made directly to the shipper rather than through Postal Service money orders.
- PRC Docket No. N89-1—Review of a Postal Service initiative to change First-Class Mail delivery standards.
- PRC Docket No. N2006-1—Review of a Postal Service initiative to realign Postal Service mail processing and transportation networks.

More recently, after the passage of the PAEA, the Postal Regulatory Commission reviewed two requests by the Postal Service for advisory opinions. See Docket Nos. N2009-1 and N2010-1.

*Docket No. N2009-1.* The Commission reviewed a Postal Service request for an advisory opinion on an initiative to rationalize and optimize Postal Service post office station and branch retail facilities. At issue in that case was the Commission's review of a focused, systemwide application of the Postal Service's station and branch discontinuance process that was initially being applied to more than 3,000 stations and branches nationwide. There were 20 participants in the Commission's proceeding, including the Postal Service and Public Representative. The participants conducted extensive written discovery. Both the Postal Service and the intervenors responded to numerous interrogatories and documents. Upon completion of discovery, the Commission held hearings on the record and received the direct and cross-examination testimony of two Postal Service witnesses as well as two rebuttal witnesses. Briefs and reply briefs were filed by seven participants. The Commission also held two field hearings: one in Independence, Ohio and one in the Bronx, New York.

This formal process culminated in the Commission issuing its advisory opinion in which it provided recommendations to the Postal Service for improving its

discontinuance process. While the Postal Service used many of the Commission's advisory opinion recommendations to form the basis of proposed changes to the Postal Service's regulations regarding post office closings and consolidations, it did not include proposed changes such as notification of appeal rights for all types of postal retail facilities and did not extend appeal rights to stations and branches. See 76 FR 41413 (July 14, 2011).

*Docket No. N2010-1.* The Commission reviewed a request for an advisory opinion on a Postal Service plan to end Saturday mail delivery, collection, and outbound mail processing. This request involved exceptionally complex issues, such as a variety of techniques used to determine sound estimates for the savings expected to result from the proposed reduction in service as well as the expected loss of revenue. The case involved several new methodologies that had not been previously investigated and tested. In addition, the Postal Service provided a novel application of market survey techniques. This examination required the Postal Service to provide access to data that were not provided at the time of filing. Adding to the complexity of the case was the fact that it required multidisciplinary analysis across several Postal Service data systems. These systems included costing, mail processing operations, delivery operations, transportation, market research, service performance, and customer relations.

The complexity of the case was further magnified by the unusually large number of participants from many different sectors of the mailing community. In total, there were 31 participants in the case, including the Postal Service and Public Representative. During discovery, the Postal Service and private parties responded to several hundred interrogatories.

Upon completion of formal discovery, the Commission held extensive public, hearings on the record and received the direct and cross-examination testimony of 11

Postal Service witnesses as well as 10 rebuttal witnesses<sup>79</sup> and 4 surrebuttal witnesses who examined the Postal Service's proposal and supporting evidence. Briefs and reply briefs were filed by ten participants. The Commission also received thousands of public comments. In addition, the Commission received statements from Members of Congress, and held field hearings in Las Vegas, Nevada; Sacramento, California; Dallas, Texas; Memphis, Tennessee; Chicago, Illinois; Rapid City, South Dakota; and Buffalo, New York.

This process culminated in the Commission issuing its advisory opinion in which it made the following key findings: (1) the annual net savings estimate from implementing the plan is expected to be \$1.7 billion (as opposed to the Postal Service's savings estimate of \$3.1 billion); (2) full savings would likely not be achieved until year three after implementation; (3) the revenue losses due to volume declines caused by the service cuts is \$0.6 billion (as opposed to the Postal Service estimate of net revenue losses of \$0.2 billion); (4) the planned changes are expected to cause an average of 25 percent of First-Class Mail and Priority Mail to be delayed by two days; and (5) the Postal Service did not evaluate the impact of the proposal on customers who reside or conduct business in rural, remote, and non-contiguous areas who are likely to be particularly affected by the Postal Service's plans.

The Commission provided its advisory opinion to the Postal Service, and to the Congress, which has maintained appropriations' language that requires the Postal Service to maintain six-day a week mail delivery since 1983.

d. Commission Experience with the Advisory Opinion Process

Overall, the Commission finds that the advisory opinion process is a positive element of title 39. The statutory provision provides a useful mechanism for the Postal Service and, where appropriate, Congress, to obtain an independent, expert view on the

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<sup>79</sup> One piece of rebuttal witness testimony was subsequently withdrawn.

merits of a Postal Service proposal to alter the nature of service on a substantially nationwide basis. In the Commission's most recent advisory opinion on the Postal Service's proposal to end Saturday mail delivery, collection, and outbound mail processing, the advisory opinion process provided the Postal Service and Congress with a thoroughly researched report that objectively reviewed the methodologies and calculations proposed by the Postal Service. Among other things, the report determined the costs and cost savings related to the annual net savings estimate of the proposal, the timeline for achieving full savings, the revenue losses due to the proposal, the service-related delays that the planned changes are expected to cause, and the likely impact of the proposed change on all segments of the public, including customers who reside or conduct business in rural, remote, and non-contiguous areas.

The advisory opinion process provides interested mail users transparency and accountability through an opportunity to participate and comment on a proposed change. It also provides mail users the ability to learn more about the details of the Postal Service's proposal. For example, in the Commission's most recent advisory opinion case dealing with the Postal Service's proposal to end Saturday mail delivery, collection, and outbound mail processing, the advisory opinion process allowed participants, including large mailers, to obtain details on exactly how the proposal could be expected to impact the dropshipping of their mail and how the proposal would affect delivery to locations that already had less than five-day-a-week delivery. The process allows the Postal Service to take into consideration suggestions received from mail users and other participants during the advisory opinion process and revise the proposal as appropriate.

e. Commission Recommendations for Legislative Change

The advisory opinion process is a positive element of title 39; however, changes to the legislative language will improve the process and provide better information on

how the Postal Service plans to implement its proposed changes in service as a result of the suggestions made in Commission advisory opinions.

Congress should consider adding statutory language that would allow the Postal Service to obtain expedited processing of Postal Service requests for Commission advisory opinions. In particular, the Commission recommends the following legislative language be considered as an addition to 39 U.S.C. 3661: “If the Postal Service seeks expedited processing for time-sensitive advisory opinions, it shall state such request in its proposal filed under subsection (b).” Including such or similar language will allow the Postal Service to obtain an advisory opinion on an accelerated schedule taking into account the complexity of the case while appropriately balancing the public’s right to obtain information. This will result in the Commission being able to provide insightful comments about Postal Service proposed changes in service consistent with Congressional and Postal Service interest in expedited advisory opinions.

The Postal Regulatory Commission also recommends that Congress consider adding language to 39 U.S.C. 3661 that requires, upon receipt of the Commission’s advisory opinion, the Postal Service provide a written response to Congress. Such response should explain how it intends to implement Commission’s recommendations or justification as to why it does not agree with the Commission’s recommendations. The Postal Service should not implement such changes until its written response has been provided to Congress. In furtherance of the PAEA and section 3661’s goal of increased transparency of the Postal Service, this will allow Congress and users of mail to see how the Postal Service plans to incorporate the Commission’s recommendations into its overall plan to change service on a nationwide or substantially nationwide basis and its rationale and justification for diverging from any Commission recommendations. Currently, the Commission’s advisory opinion is required only to be provided to the Postal Service. The proposed change would require both the Commission’s advisory opinion and the Postal Service’s written response to be submitted to Congress for appropriate review and oversight.

Furthermore, requiring a timely Commission decision and the Postal Service to provide such written response in advance of implementation ensures that the Postal Service is able to consider thoroughly the opinion and provide justifications for its response.

Requiring a Federal agency to provide a written response to the Commission's suggestions is supported by precedent in another provision of the PAEA. In PAEA section 802(c), upon request of the Postal Service, Congress requires the Commission to produce a report that reviews certain calculations of OPM related to the Postal Service's Civil Service Retirement System liability. Upon receipt of the Commission's report, the PAEA requires that OPM:

shall reconsider its determination or redetermination in light of such report, and shall make any appropriate adjustments. The Office shall submit a report containing the results of its reconsideration to the Commission, the Postal Service, and Congress.

PAEA section 802(c)(2).

On February 23, 2010, as modified on March 2, 2010, the Postal Service requested that the Commission produce such a report. The Commission issued its report on June 30, 2010. Upon receipt of the Commission's report, OPM reconsidered its determination in light of the Commission's recommendations and submitted the results of OPM's reconsideration to the Commission, the Postal Service, and Congress on September 24, 2010.

Language similar to PAEA section 802(c) may be appropriate to require the Postal Service to "reconsider" its proposed plan in light of the advice it has received and "submit a report containing the results of its reconsideration to the Commission...and Congress." *Cf.* PAEA section 802(c).

## CHAPTER V: CONCLUSION

The Commission appreciates the opportunity to contribute to this important policy review by providing a 701 report every five years to measure the effectiveness of the PAEA. As a matter of practice, the Commission finds that the PAEA is generally functioning as Congress intended. The United States Postal Service has utilized the flexibilities granted by the law as described in this report with varying degrees of success.

In this, the Commission's first 701 Report, we have identified areas where key adjustments to postal laws could help address the liquidity crisis facing the Postal Service and better inform Congress and the mailing public.

The recommendations in this report are not proposed with the expectation that, if adopted, they may resolve all of the Postal Service's difficulties. However, this report highlights areas where there are opportunities for short-term remedies. Implementation of these recommendations would improve the Postal Service's current financial situation in the near term and provide opportunities to more fully assess long-term solutions.

PATRICK R. DONAHOE  
POSTMASTER GENERAL, CEO



**Postal Regulatory Commission  
Office of the Chief Admin. Officer**

**SEP 16 2011**

**September 16, 2011**

**The Honorable Ruth Y. Goldway  
Chairman  
Postal Regulatory Commission  
901 New York Avenue, NW, Suite 200  
Washington, DC 20268-0001**

**Dear Chairman Goldway:**

**I am hereby transmitting to the Postal Regulatory Commission the Postal Service's comments on the draft report prepared by the Commission pursuant to Section 701 of the Postal Accountability and Enhancement Act, Public Law 109-435, 120 Stat. 3198, 3242, and 3243. As you know, Section 701(b) of the Act requires that these comments be attached to the final report issued by the Commission to the President and Congress. I look forward to reviewing the final report.**

Sincerely,

A handwritten signature in blue ink, appearing to read "P. Donahoe".

**Patrick R. Donahoe**

**Attachment**

701 Report

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**UNITED STATES POSTAL SERVICE RESPONSE  
TO COMMISSION'S DRAFT SECTION 701 REPORT****September 15, 2011****I. INTRODUCTION**

On August 8, 2011, the Postal Service received a copy of the Postal Regulatory Commission's (Commission's) draft report under Section 701 of the Postal Accountability and Enhancement Act of 2006 (PAEA), Pub. L. No. 109-435. Subsection 701(a) requires the Commission, at least every five years from the PAEA's enactment date, to "submit a report to the President and Congress concerning (1) the operation of the amendments made by [the PAEA]; and (2) recommendations for any legislation or other measures necessary to improve the effectiveness or efficiency of the postal laws of the United States." Subsection 701(b) further requires the Commission to afford the Postal Service a "reasonable opportunity ... to review the report and to submit written comments on the report," which must be attached to the version submitted to the President and Congress.

Because it is the first such report under the PAEA and because of the Postal Service's currently dire financial condition, this year's report represents an historic opportunity to recommend amendments to the PAEA that would directly address the new postal business reality and give the Postal Service a sustainable future. The Postal Service agrees with the Commission that restructuring of the onerous retiree health benefits (RHB) prefunding payments is a critical step towards improving the financial situation of the Postal Service. At

the same time, however, improving the Postal Service's financial stability in both the short-term and the long-term requires more comprehensive changes than are discussed in the Commission's draft report. The Postal Service hereby submits its comments on the effectiveness of the PAEA and recommends changes to the law that would enable the Postal Service to restore itself to financial solvency in order to continue providing universal service to the nation.

The Postal Service wishes to stress that the pace of change in the demand for the mail, and the impact of that changing demand on postal finances and the service that the Postal Service provides to our nation, will continue to be volatile. This makes it critical that changes be made now that give the Postal Service the necessary flexibility to respond quickly and effectively to both the current dire financial circumstances, and any future circumstances that may arise. Additionally, given the pace of change, an ongoing review and evolution of the Postal Service's business model will be required to ensure that the Postal Service continues to have the flexibility and tools going forward to adapt to forces around it and continue to provide universal service.

## **II. THE POSTAL LAWS NEED SIGNIFICANT REFORM TO ENSURE STABILITY AND THE CONTINUED PROVISION OF UNIVERSAL SERVICE**

These Postal Service comments are arranged in four broad sections. The first section outlines the ways in which events since the enactment of the PAEA have threatened the Postal Service's stability. The second section offers recommendations for additional tools to control costs, which are critically necessary if the Postal Service is to regain financial stability. The third section addresses pricing flexibility and discusses the role that post-PAEA

implementation has played in limiting, rather than expanding, the revenue-raising tools available to the Postal Service. The final section analyzes the Commission's evaluation of various regulatory areas and its recommendations in the Draft Report, as well as those of the State Department. The Postal Service presents alternative recommendations for consideration, where appropriate.

**A. The Assumptions Underlying the PAEA Are No Longer Valid**

The PAEA resulted from years of significant debate and hard work by members of Congress and other postal stakeholders. The Postal Service is appreciative of the efforts of Congress and all those involved in creating the PAEA. Given what was known at the time, it appeared to most that, when the PAEA became law, it would enable the Postal Service to finance universal service well into the future. Unfortunately, this did not prove to be the case, because the assumptions underlying the PAEA were no longer valid as the nation fell into recession, and mail volumes plummeted.

In enacting the PAEA, Congress implicitly assumed that the Postal Service could maintain financial stability in the face of electronic diversion and the accelerated RHB prefunding schedule by raising prices up to the change in consumer inflation, generating additional revenue through pricing and product innovations spurred by the removal of the Postal Reorganization Act's (PRA's) constraints, and cutting those costs within the Postal Service's control. This assumption explains the three central policy choices made by the PAEA: prices for market-dominant prices (which account for nearly 90 percent of Postal Service revenue) would be capped at the level of consumer inflation, the Postal

Service was to prefund retiree health benefits on an accelerated schedule, and the Postal Service would receive no augmented authority to reduce its costs. A necessary predicate of this assumption was that volume trends in the middle of the last decade – characterized by gradually declining First-Class Mail and stable or rising Standard Mail – would persist for a period of time. If this had occurred, the Postal Service would have had an opportunity to put its cost-cutting and product innovation strategies into place in order to maintain financial stability while making its prefunding payments, which were going to be a significant short-term challenge even under normal circumstances.

That the PAEA would not obviate the need for additional reform at some point in the future was implicitly understood, as volume would eventually reach a level that would necessitate downsizing not achievable under the PAEA. Indeed, the law itself recognized this because of the numerous studies and analyses it required. However, there is no inherent reason that the PAEA could not have been successful for some time, had volumes not declined so precipitously during the period which coincided with the recession and the continuing economic weakness.

Neither Congress, nor the Postal Service, nor other stakeholders anticipated at the time the PAEA was enacted either the severity of the recession that began soon afterwards or the extraordinary volume declines that occurred during that period. In the fiscal year that ended just prior to the enactment of the PAEA (FY 2006), the Postal Service had its highest volume ever, totaling 213 billion pieces of mail. While the threat of electronic diversion was well-

understood, it was not expected that First-Class Mail volume would thereafter decline by an estimated 25 billion pieces, or 26 percent, from its FY 2006 level through the end of this fiscal year. This vastly exceeded the decline for the previous five year period, in which First-Class Mail declined by a total of 6 billion pieces. While the long-term challenges due to the electronic diversion were a problem that the Postal Service had anticipated and planned for, the decline in mail volumes since the economic downturn began has been nothing short of staggering, compressing what was seen as a long-term, gradual decline into only a few years. Furthermore, it was certainly not expected that Standard Mail volume would decline by an estimated 19 billion pieces, or 18 percent, from FY 2006 levels, after growing for most of the decade. Going forward, the Postal Service expects First-Class Mail volume to continue to decline at a significant pace, while Standard Mail volume will be flat. The end result is a grave mismatch between the Postal Service's revenues and its costs.

In the face of such precipitous volume declines, the tools available to the Postal Service under the PAEA were simply not sufficient to maintain the Postal Service's financial solvency. First, despite the recommendations of the President's Commission, the PAEA gave the Postal Service no new authority to cut labor and network costs. Second, the PAEA's enhanced pricing and product tools could not stem the tide of billion-fold revenue losses as volumes declined due to macroeconomic factors. As a result, the Postal Service could not realistically match the lost revenue from the volume declines through cost reductions, considering its structural network costs and labor costs (including the

accelerated prefunding payments), which continued to rise without regard to the rate of consumer inflation,<sup>1</sup> or through the introduction of new products or pricing initiatives.

Nor could the Postal Service maintain financial stability through application of the price cap. The price cap is not well-suited to a period of rapidly declining volumes: as volumes decline, the remaining volume does not provide enough contribution to cover the Postal Service's fixed costs, imposed either by the nature of the work performed by the Postal Service (acceptance and delivery of hardcopy mail throughout the entire nation) or by statute. The price cap, based on an index that measures general price levels in the economy, does not consider Postal Service volume changes or the fact that the Postal Service's fixed costs generally rise at levels independent of the trends in consumer inflation.<sup>2</sup>

Furthermore, not only did volumes decline much more rapidly than was ever expected at the time the PAEA was enacted, but the price cap index (the

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<sup>1</sup> For instance, even as volumes have declined by 20 percent from their FY 2006 peak through the end of the last fiscal year, the delivery network increased by 3 percent in that time period as the result of the addition of new delivery addresses.

<sup>2</sup> See, e.g., *H.R. 22, The Postal Reform Act of 1997: Hearing Before the Subcomm. on the Postal Service of the House Comm. on Government Reform and Oversight*, 105th Cong. 249-50, 259-60, 268 (1997) (statements of Dr. Laurits R. Christensen and Dr. William J. Baumol). Indeed, during the legislative debate on bills that led up to the PAEA, the Postal Service warned that a CPI cap could only work in conjunction with an appropriate measure of new cost-control authority. See, e.g., *U.S. Postal Service: What is Needed to Ensure its Future Viability?: Hearing Before the Senate Comm. on Homeland Security and Governmental Affairs*, 109th Cong. 58-63 (2005) (statement of Postmaster General/CEO John E. Potter) (noting the importance of comprehensive reform that did not rely solely on a price cap and enhanced pricing flexibility, but also addressed Postal Service costs and service levels); *The Postal Service in Crisis: A Joint Senate-House Hearing on Principles for Meaningful Reform: Hearing Before the House Comm. on Government Reform and the Senate Comm. on Governmental Affairs*, 108th Cong. 70-74 (2004) (statement of Postmaster General/CEO Potter) (advising that comprehensive reform was particularly important because mail volume and revenue trends were inherently uncertain, and that maintaining financial solvency therefore required that "a price cap be just one element of comprehensive reform legislation that provides the Postal Service with flexibility in other critical areas").

Consumer Price Index for All Urban Consumers, or CPI-U) became negative during the recession. Given that there had not been a comparable period of declining CPI-U since the 1950s, there was little expectation when the PAEA was passed that CPI-U would be negative for a sustained period of time. While this helped the Postal Service in some respects, such as by eliminating cost-of-living adjustments, significant cost inputs outside of the Postal Service's control continued to rise without regard to the overall decline in CPI-U. The Postal Service was therefore unable to address those increased structural costs through price increases, either through the use of the CPI-based cap, or, following the Commission's denial of its request, through the use of the safety-valve exigency provision. Indeed, the prices for market dominant products remained unchanged for two years, even as the Postal Service's financial situation deteriorated.

The Postal Service now faces a situation in which its volume and revenue are substantially less than stakeholders expected at the time the PAEA was debated and enacted.<sup>3</sup> Furthermore, there is no reasonable expectation that this lost volume will ever return. The Postal Service projects that volumes will decline at a consistent pace: by 2015, the Postal Service currently projects volumes of 151 billion, and by 2020, volumes of 133 billion. The biggest decreases will occur in First-Class Mail, the Postal Service's most profitable product. Thus, the mail mix will increasingly be weighted towards lower-margin products, particularly

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<sup>3</sup> For instance, the President's Commission had projected volume of 201.5 billion pieces in FY 2012 under a scenario of "gradual displacement" of the mail by electronic means. REPORT OF THE PRESIDENT'S COMMISSION ON THE UNITED STATES POSTAL SERVICE, EMBRACING THE FUTURE: MAKING THE TOUGH CHOICES TO PRESERVE UNIVERSAL MAIL SERVICE (2003) (*hereinafter* "President's Commission Report"), at iv. The Postal Service currently projects that volume for FY 2012 will be 161 billion pieces.

Standard Mail, which will further impede any improvement in net financial results. This fact is demonstrated by the results in the third quarter of FY 2011: while market-dominant mail volume dropped by only 2.7 percent from SPLY, Postal Service revenue still declined by 3.1 percent, reflecting the continued decline of First-Class Mail notwithstanding an increase in Standard Mail.<sup>4</sup> This is because it takes roughly 3 additional pieces of Standard Mail to compensate for the loss of a single piece of First-Class Mail, and any such volume growth in Standard Mail is unrealistic. Thus, as the Commission noted earlier this year, the Postal Service cannot count on a rebound in the economy to significantly improve its financial results.<sup>5</sup>

**B. The Postal Service Needs Additional Authority to Control Costs**

The economic slowdown and its significant – and continuing – impact on the rate of mail volume decline have therefore placed the Postal Service at the brink of collapse under the structure put in place by the PAEA. Significant actions must be taken to revamp postal law so that financial stability can be restored and maintained, considering the Postal Service's current financial situation and projected volume and revenue trends, expected trends in input costs, and necessary capital investments to preserve high-quality service. To restore and thereafter maintain financial solvency, the Postal Service needs the authority to comprehensively address both its labor costs and its infrastructure costs. On the labor side, the Postal Service must address its legacy costs, including its pension and health benefit liabilities. One alternative recently

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<sup>4</sup> Postal Service, Form 10-Q (August 5, 2011), at 22.

<sup>5</sup> FY 2010 Annual Compliance Determination at 34.

proposed by the Postal Service would be to give the Postal Service the authority to manage the administration of its legacy costs (in particular, health care costs) in a more efficient manner, as well as the tools to better match the size of its workforce with its financial resources. In addition, the Postal Service must be given the authority to address all facets of its retail, processing, and delivery networks. The Postal Service must be given not only the ability to control costs through flexibility over the number of delivery days, but also the enhanced ability to replace unprofitable postal retail facilities with alternative access channels free from statutory restrictions and political or regulatory interference, and to consolidate mail processing plants free of political interference.

#### **1. Labor Costs**

The Commission's analysis and current legislative proposals rightly address RHB prefunding and pension overpayments, but these solutions do not remedy the long-term problem: the magnitude of the Postal Service's benefits liabilities and other labor-related costs. The Postal Service must be given the tools to reduce the size of its liabilities – particularly its health benefits liability – if it is to become financially sustainable over the long-term.

The RHB prefunding schedule is the clearest sign that the PAEA was premised on overly optimistic assumptions, and the Postal Service agrees with the Commission that the schedule needs to be addressed. The Postal Service also agrees with the Commission that one approach to addressing the RHB issue would be to correct the overfunding of the Civil Service Retirement System (CSRS) identified by the Postal Service Office of Inspector General (OIG) and

the independent actuary retained by the Commission, and to use that money to satisfy the RHB prefunding payments.<sup>6</sup> This approach has been proposed in separate pieces of legislation by Senator Collins, Senator Carper, and Representative Lynch.<sup>7</sup> Another approach would be to amend the manner in which the RHB prefunding occurs to reflect a more measured approach than the accelerated schedule imposed by the PAEA and to require payment of this long-term liability over the long term, consistent with normal actuarial practice.

However, simply amending the RHB prefunding schedule is not sufficient to restore short-term solvency to the Postal Service, much less its long-term solvency. In the short-term, even if the Postal Service does not make the RHB payment at the end of this fiscal year, it will be dangerously low on cash in October of this year, and would experience a cash shortfall at some point during fiscal year 2012. Therefore, additional measures are necessary to ensure short-term solvency. One clear source of additional funds is the Postal Service's overfunding of the Federal Employee Retirement System (FERS), which amounts to approximately \$6.9 billion, and which should be refunded. There is no dispute that this overfunding exists, nor is there any actuarial or principled reason why it should persist. Congress should address the overfunding in a way that provides immediate liquidity: providing an immediate refund is an essential tool to restoring short-term liquidity to the Postal Service, thereby helping to avoid complete insolvency in FY 2012.

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<sup>6</sup> See Draft Report at 2.

<sup>7</sup> S. 353, 112th Cong. § 101 (2011) (Collins); S. 1010, 112th Cong. § 101 (2011) (Carper); H.R. 1351, 112th Cong. §§ 2-3 (2011) (Lynch).

In addition, changing the manner by which the RHB liability is funded does not address the fact that, over the long term, the size of that liability is simply unaffordable as volumes continue to decline. A truly sustainable approach – and the one favored by the Postal Service – must lead to a reduction in the Postal Service's long-term benefits liabilities. One means of doing so is to allow the Postal Service to create its own health benefits plan, separate from the federal plan, which would, among other things, involve better coordination with Medicare.

The Postal Service also needs to achieve savings in pension costs. At a minimum, the Postal Service believes it should have the authority to offer a defined contribution pension plan to future employees. This would begin to moderate long-term pension liabilities.

Also essential to helping the Postal Service regain long-term financial stability is the necessity of providing the Postal Service with tools to reduce the size of its workforce. Over the next three years, the Postal Service will need to reduce its career complement by approximately 220,000 employees in order to match costs with projected revenues. Attrition will only lead to a reduction of approximately 100,000 employees. The layoff provisions in the postal collective bargaining agreements prevent the Postal Service from reducing the size of its workforce by the additional amount that is necessary. To achieve the further complement reductions that are financially necessary, the Postal Service must be given the ability to reduce the size of the bargaining-unit workforce through use of the Reduction-in-Force (RIF) rules applicable to federal employees in the competitive service, without application of the layoff provisions. While this would

be an extraordinary step and one the Postal Service does not pursue lightly, extraordinary circumstances require extraordinary remedies, and the Postal Service does not believe, based on the history of collective bargaining and interest arbitration, that it will be able to modify layoff protections sufficiently through the current collective bargaining process.

Finally, the Postal Service supports reforms to the workers' compensation system, particularly the reform that would require recipients of workers' compensation benefits to retire when they become eligible. Legislation on this issue has been introduced by Senator Collins.<sup>8</sup>

## **2. Infrastructure Costs**

In addition to reducing labor costs, the Postal Service must also be given the clear authority to right-size its network costs to reflect the environment of significantly reduced volume. The Postal Service must evolve as demand for postal services changes, and its current operating structure becomes financially unsustainable. The President's Commission recognized this essential fact, noting that the Postal Service must be given greater flexibility over its retail, processing, and delivery networks.<sup>9</sup> Legislative change is necessary regarding the delivery and retail networks.

Obtaining flexibility over delivery frequency is an essential aspect of right-sizing the Postal Service for the new environment in which it must operate. Senator Carper and Representative Issa have introduced bills that would allow

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<sup>8</sup> S. 353, §§ 301-303.

<sup>9</sup> President's Commission Report at 28-29, 79-84.

the Postal Service to move to a five-day delivery plan.<sup>10</sup> While it did not reach a decision in response to the Postal Service's request for an advisory opinion, the Commission has previously recognized that five-day delivery is consistent with the provision of universal service.<sup>11</sup> The Postal Service's plan represents a careful assessment of customer needs and would also significantly improve the Postal Service's bottom line, regardless of whether the Postal Service's or the Commission's savings estimates are used. Indeed, even if the Commission's estimates are accepted for the sake of argument (though the Postal Service strongly believes that its own estimates are more accurate), annual cost savings of \$1.7 billion would be extremely significant.

The Postal Service must also rationalize its retail network. The Postal Service currently has too many under-performing post offices, which can be replaced with more robust and cost-effective means of providing access to postal services. In the last year, the Postal Service has undertaken various measures to right-size its retail network, including those outlined in Commission Docket No. N2011-1. Such measures are subject to statutory restrictions, however, and greater legal clarity is therefore appropriate. Senator Carper's bill would implement a necessary change to 39 U.S.C. § 101(b), which currently requires that the Postal Service provide "a maximum degree of effective and regular postal services" to rural areas, and to refrain from closing small post offices "solely for operating at a deficit." The Carper bill would still require that the Postal Service provide "effective and regular postal services" to all areas,

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<sup>10</sup> S. 1010, § 205; H.R. 2309, 112th Cong. § 111 (2011).

<sup>11</sup> Postal Regulatory Commission, REPORT ON UNIVERSAL POSTAL SERVICE AND THE POSTAL MONOPOLY 18 (2008) (*hereinafter* "USO Report"), at 123.

including rural areas, but would give the Postal Service the flexibility to choose the means by which this service is provided.<sup>12</sup> Independent post offices, staffed by postal employees, would not be required if universal service is adequately provided through alternate means. This is consistent with the recommendations of the President's Commission.<sup>13</sup>

Addressing the Postal Service's cost structure is vital to ensuring that the mail remains competitive, affordable, and relevant going forward. At the same time, if Congress believes that the social policies underlying particular labor and service level requirements should be maintained despite current and expected First-Class Mail volume declines, then the law should be revised to ensure that the Postal Service can generate sufficient revenue to remain solvent in light of those requirements.

The PAEA's imposition of a price cap system has been an improvement over the old structure in many respects. The acceleration of efficiency gains by the Postal Service from the already aggressive pace prior to the passage of the PAEA demonstrates that Congress was correct in disregarding concerns expressed during the reform process that a price cap could not be applied to the Postal Service, which lacks residual claimants in the form of shareholders.<sup>14</sup> Indeed, a more relevant concern – also expressed prior to the PAEA – is that providing incentives for efficiency is of limited value if management lacks the

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<sup>12</sup> S. 1010, § 201.

<sup>13</sup> President's Commission Report at xiv, 81-84.

<sup>14</sup> See, e.g., H.R. 22, *The Postal Reform Act of 1997: Hearing Before the Subcomm. on the Postal Service of the House Comm. on Government Reform and Oversight*, 105th Cong. 107-108 (1997) (statement of Dr. Michael Crew and Dr. Paul Kleindorfer).

tools to take the actions that are necessary to operate under the cap.<sup>15</sup> If the tools to control cost inputs are not provided, as was the case with the PAEA, then the price cap system should take into explicit account those cost inputs that are outside of management's control.

**C. The Regulatory Approach Can Be Improved to Expand Pricing Flexibility**

While the PAEA intended to enhance the Postal Service's pricing flexibility for all types of postal products, Congress did include restrictions on the Postal Service's flexibility to price market dominant products under the CPI-U cap. As a procedural matter, the Postal Service agrees with the Commission that the new system is a significant improvement over the old, as prices can now be changed more expeditiously: a litigious process that used to take up to 10 months for the Commission to review proposed prices is now accomplished much more quickly for both market dominant and competitive products.<sup>16</sup> Changes to product parameters, such as the change to allow all stamps to be treated as Forever stamps, are also reviewed on a relatively quick timeframe by the Commission under its regulations.

As a substantive matter, however, the PAEA's results are mixed in terms of giving the Postal Service true pricing flexibility. The Postal Service is able to introduce new prices or temporary discounts and to test experimental products

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<sup>15</sup> See, e.g., Robert A. F. Reisner, Global Insight, "Price Caps and the U.S. Postal Service: Prospects, Perils and the Public Interest" (2003), at 9.

<sup>16</sup> However, the benefits of this change are mitigated by the fact that the Commission requires prior reviews of all pricing and cost methodology changes, even when such reviews are not required by the statute; the statute, for instance, only requires a before-the-fact review to ensure compliance with the price cap, but the Commission's review procedure is substantially broader. In addition, the Commission reviews every competitive price change before-the-fact, including individual negotiated service agreements, although such review is not required or necessary.

more quickly than it was before the PAEA. The Postal Service has taken advantage of this increased flexibility to introduce a number of pricing initiatives in order to attract and retain mail volume, which would not have been feasible under the prior system. These initiatives included "Summer Sales" for Standard Mail in 2009 and 2010, a First-Class Mail Incentive program in the fall of 2010, Saturation Mail and High Density Incentives, the Reply Rides Free incentive, and an incentive to encourage the use of multi-dimensional barcodes on mail pieces.

For changes to existing prices, some degree of enhanced flexibility is inherent in the fact that, unlike the prior system in which prices were recommended by the Commission and could only be overridden by the Postal Service's Governors in limited circumstances, the Postal Service can now design prices, with the Commission simply reviewing those prices for compliance with the statute. However, the Commission has imposed numerous restrictions on the Postal Service's ability to exercise business judgment in pricing. Some of these are the result of clear statutory language, rather than Commission action, such as the rigid preferential pricing rules of 39 U.S.C. § 3626, and the application of the price cap at the class level rather than to market-dominant products as a whole.<sup>17</sup> At the same time, however, the Commission has interpreted the language of other provisions of the statute in a way that has unnecessarily restricted the Postal Service's pricing flexibility. This has led to a situation in which, as applied by the Commission, a price cap has essentially

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<sup>17</sup> This is a significant limitation: under the PRA, an important pricing tool was the reallocation of institutional costs across the subclasses of mail, based on the factors of former 39 U.S.C. § 3622, as conditions changed. This is largely precluded under the PAEA's price cap system, because the price cap applies to each class of mail.

been overlaid upon a system that perpetuates many of the substantive rigidities of pricing under the PRA.

Two decisions of the Commission stand out. First, the Commission's application of the workshare provision (39 U.S.C. § 3622(e)) to the relationship between single-piece First-Class Mail and commercial First-Class Mail, combined with the cap, reduces much of the Postal Service's pricing in First-Class Mail, its most profitable product, to be more an exercise in arithmetic rather than one in strategic marketing. Second, in its most recent Annual Compliance Determination, the Commission interpreted 39 U.S.C. § 101(d), a general policy provision held over from the PRA, as imposing a specific requirement that each market dominant product cover its costs. As a result, the Commission ordered the Postal Service to concentrate price increases on Standard Mail Flats, notwithstanding whether the Postal Service believes a different approach would be a more prudent exercise of pricing flexibility. This compels Postal Service pricing decisions that may not be optimal given current market conditions. Whether these decisions are consistent with the language of the statute is currently before the United States Court of Appeals for the District of Columbia Circuit.<sup>18</sup>

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<sup>18</sup> See *U.S. Postal Serv. v. Postal Reg. Comm'n*, No. 10-1324 (workshare); *U.S. Postal Serv. v. Postal Reg. Comm'n*, No. 11-1117 (Annual Compliance Determination).

Additionally, the Postal Service disagrees with the Commission's characterization in the report of a recently resolved judicial appeal that involved a Postal Service request for a market dominant price change due to extraordinary or exceptional circumstances. As explained before the United States Court of Appeals for the District of Columbia Circuit and in the Postal Service's subsequent submissions to the Commission, the Postal Service filed ample materials to support the relation of its request to the identified circumstances, and nothing in the Court of Appeals decision indicates anything to the contrary. See *United States Postal Serv. v. Postal Reg. Comm'n*, 640 F.3d 1263 (2011). While the Postal Service wishes to make clear that it does not believe the Commission's characterizations are accurate, the Postal Service also does not

Regardless of the ultimate outcome of these cases, the Commission has approached the PAEA in a manner that limits rather than enhances the Postal Service's flexibility to make its own business decisions. More, not less, pricing flexibility is needed to help the Postal Service tackle unusual financial threats like those that have prevailed since the PAEA's enactment. Even in less dire times, the Postal Service needs the ability to react swiftly and nimbly to a dynamic marketplace, rather than being trapped amid an overly rigid pricing scheme. This is particularly true as the Postal Service develops hybrid and digital services in response to needs of the marketplace.

**D. Analysis of Regulatory Suggestions**

**1. Market Dominant Pricing**

**a. Price Cap**

Any analysis of "pricing flexibility" must acknowledge the multitude of factors and objectives in 39 U.S.C. § 3622(b) and (c), and should not be overly focused on the goal of ensuring product-specific cost coverage.<sup>19</sup> Congress's careful requirement to balance such factors and objectives recognizes that an undue concentration on product-specific cost coverage can be counter to sound business judgment and the interest of sustaining Postal Service finances. For instance, it might be more rational, in some cases, to aim price increases at profitable products with lower demand elasticity than unprofitable products, because the increased revenue would more likely be realized from customers of the former products than from those of the latter. A truly flexible system, as

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believe that a comprehensive discussion of those inaccuracies is relevant or necessary to the purposes of this report.

<sup>19</sup> See Draft Report at 35.

Congress intended, is one that acknowledges that some interests (such as raising revenue to sustain the postal system overall) can take precedence over others (such as the aim of product-specific cost coverage), depending on the circumstances.

To increase pricing flexibility, the Postal Service proposes that Congress apply the price cap to market dominant products as a whole, rather than to each class. This would augment the Postal Service's ability to price under the cap in a commercially reasonable manner, based on demand and unit costs, while also adhering to the other requirements imposed by law. Over time, enhanced flexibility would also allow the Postal Service to address the cost coverage of products that are currently priced below cost.

**b. Price Change Schedule**

The draft report discusses the pros and cons of the Postal Service's decision to file market dominant price adjustments in January.<sup>20</sup> As the Commission acknowledges, the scheduling of price adjustments is left flexible, subject to the Postal Service's discretion and business judgment. The Postal Service agrees with the Commission that there is no need to make any adjustment to the PAEA in this respect.

**c. Quality of Service Adjustment Factors and Other Examination of the Price Cap System**

The draft report offers a novel suggestion to allow the Postal Service's market dominant pricing authority to be adjusted upward in response to

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<sup>20</sup> Draft Report at 38-40.

improvements in service performance.<sup>21</sup> The Postal Service applauds the Commission's creativity and interest in opening a dialogue on the price cap regime. However, the Postal Service believes that, rather than introducing further regulation of the Postal Service's value propositions, the more crucial and pressing need is for reforms that give the Postal Service additional tools to set its prices in accordance with market principles.

If the price cap should be open to revision at this time through the introduction of an adjustment factor based on service quality, then the examination of the cap in a more comprehensive fashion is likewise warranted. More meaningful reforms to the price cap are in order, given the current financial condition of the Postal Service. Examination of such reforms would include reconsideration of whether CPI-U is an appropriate index, as opposed to alternative inflation indices, and whether additional adjustment factors are necessary to account for cost and market forces unique to the Postal Service.<sup>22</sup>

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<sup>21</sup> *Id.* at 40.

<sup>22</sup> For example, the statute could be revised to gear pricing around an alternative index that better reflects the Postal Service's cost profile, with adjustments to continue to incentivize efficiency and productivity gains. During the postal reform negotiations that culminated in the PAEA, the Postal Service proposed a cap, 80 percent of which constituted the change in the Employment Cost Index (ECI), with the other 20 percent constituting the change in the Gross Domestic Product Chain-Type Price Index (GDPPI). The ECI measures changes in the cost of labor, including salaries and benefits, while GDPPI is a broad measure of prices across the economy that reflects all of the goods and categories included in the Gross Domestic Product. GDPPI measures more goods and services than CPI does, as CPI focuses only on the average price of those goods and services purchased by a typical household. Neither the ECI nor the GDPPI experienced the significant declines that CPI-U did over the past several years. In addition, an index based primarily on ECI reflects the fact that the vast majority of the Postal Service's costs are labor costs. The maintenance of an indexed price cap would continue to incentivize cost-cutting by the Postal Service to keep pace with the private sector as a whole, but an ECI-GDPPI cap would reflect the realities of the Postal Service's cost profile better than CPI-U does.

The market-dominant pricing mechanism could also require use of adjustment factors other than that proposed by the Commission. In one example of such a pricing system, the United Kingdom's postal regulator, Postcomm, employs an "X" factor to adjust Royal Mail's inflation-based price increases. In calculating the "X" factor at the beginning of the periodic price control, Postcomm makes a number of assumptions in order to ensure that the price control will

#### d. Preferred Rates

The Postal Service recommends that the Congress address the role of preferential rates for certain classes of mail. Under PRA provisions left largely unaffected by the PAEA, the Postal Service is required to adhere to rigid numerical benchmarks in pricing certain preferential categories of mail. For instance, the prices for Library Mail must be 5 percent lower than the prices for the most closely corresponding regular-rate category, Media Mail. This inhibits the Postal Service's pricing flexibility with respect to preferred-rate categories.

It might also prevent the benchmarked regular-rate categories from being properly placed on the competitive side, regardless of how they might compete in the market: because the preferential categories are required by law to be priced as market dominant products, it would appear that the regular-rate categories to

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allow Royal Mail, the U.K.'s public postal operator, to earn sufficient revenue to provide universal service. The X factor incorporates assumptions regarding future volumes, operating and capital expenditures, and pension deficit contributions, as well as an appropriate profit allowance. At the same time, Postcomm establishes efficiency savings that it believes Royal Mail should achieve during the price control. Postcomm has established other adjustment factors that account for severe volume changes (the "G" factor) and unfunded pension obligations (the "PP" factor), which, if applied in the United States, could add helpful correctives for volume-related revenue losses and structural benefits costs outside of the Postal Service's control.

In the recent exigent price change case, volume losses played a significant role and the Commission's ruling hinged in part on its opinion that "long-term structural problems," including in particular the RHBF prefunding requirement, were responsible for the Postal Service's urgent revenue needs. PRC Order No. 547, Order Denying Request for Exigent Rate Adjustments, Docket No. R2010-4, September 30, 2010, at 3, 68-80.

It should be noted that postal reform bills leading up to the PAEA would have required the use of GDPPI and/or an adjustment factor similar to the X factor. H.R. 22, 106th Cong. § 201 (1999) (CPI with adjustment factors taking into account, among other items, "new and significant statutorily imposed funding obligations not fully funded through appropriations," postal deficits notwithstanding "best practices of honest, efficient, and economical management," and Postal Service costs and productivity); H.R. 22, 105th Cong. § 1001 (1997) (GDPPI with adjustment factors taking into account, among other items, Postal Service costs and productivity and "such other considerations as the Postal Service and the Commission mutually agree to be appropriate"); H.R. 3717, 104th Cong. § 1001 (1996) (same); *see also* H.R. 22, 109th Cong. § 201 (2005) (passed in House) (CPI with exception if requested rates are "reasonable and equitable and necessary to allow the Postal Service, under best practices of honest, efficient, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States").

which they are rigidly tied also must remain on the market dominant side. To enhance pricing flexibility, the rigid benchmarks should be replaced with more flexible standards for discounting, and the Postal Service should be allowed to manage its products according to their actual market status.

## **2. Nationwide Changes in Service**

Senator Carper has suggested in his bill that the Commission should be explicitly required to issue an advisory opinion on large-scale service changes under 39 U.S.C. § 3661 within 90 days, and that the formal hearing requirement should be removed from the advisory opinion process.<sup>23</sup> The Carper bill would also not apply the advisory opinion process to competitive products. Although the Commission historically has not issued advisory opinions within 90 days, this timeframe would be consistent with the current Commission rules governing advisory opinion procedures, which require the Postal Service to file its request at least 90 days before the service change's planned effective date. 39 C.F.R. § 3001.72. A 90-day period would also be consistent with other complex proceedings under the PAEA, including the Commission's review of exigent price change requests and the Annual Compliance Determination process, which the Commission conducts without the burdensome and lengthy formal hearing process. See 39 U.S.C. §§ 3622(d)(1)(E), 3653(b). This clear timeframe and lifting of disproportionate administrative requirements would provide the expedition needed in advisory opinion proceedings, while ensuring a level of Commission analysis consistent with its work in other areas. Senator Carper's

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<sup>23</sup> S. 1010, § 206.

approach is clearly preferable to that set forth by the Commission in the draft report.<sup>24</sup>

### **3. Post Office Closings and Consolidations**

#### **a. Reporting on Retail Network Plans and Activities**

The draft report proposes that Congress require the Postal Service to provide regular reports to the Commission on the Postal Service's retail network plans and activities, including "information on how particular closings conform with previously filed plans and alternative access."<sup>25</sup> The Postal Service appreciates the important interests in transparency and accountability, which the Commission correctly identifies as animating the PAEA.<sup>26</sup> However, additional reporting would not provide any appreciable benefit in this regard, given the extensive reporting and information-gathering about the retail network that occurs in the course of the Annual Compliance Report/ Determination proceedings. Moreover, there is significant transparency in the process used to consider discontinuance of post office closings and consolidations. With respect to operational decisions that Congress has placed beyond the Commission's regulatory purview, the Postal Service already must account to Congress and the public. Thus, it is unclear how "Congress, the public, and the Commission" could stand to be any "better informed" than they are today.<sup>27</sup>

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<sup>24</sup> The draft report proposes a change whereby the Postal Service could be authorized to request expedition, but such a recommendation would not provide the actual assurance of expedition offered by Senator Carper's bill. It should be noted that the PAEA currently does not prevent the Postal Service from requesting expedited treatment. Mandating a set timeframe would provide the necessary assurance of timely advice, as opposed to leaving the schedule up to administrative discretion.

<sup>25</sup> Draft Report at 71-72, 77.

<sup>26</sup> *Id.* at 78.

<sup>27</sup> *See id.* at 77.

### b. Postal Service Rulemaking

The draft report discusses a recent Postal Service rulemaking to revise its regulations concerning the closure or consolidation of Postal Service-operated retail facilities.<sup>28</sup> In connection with the rulemaking, the draft report also cites “the notable exception [to Commission suggestions adopted by the Postal Service] of potential appeal rights to postal patrons for discontinuance decisions involving a post office station or post office branch.”<sup>29</sup> In fact, the rulemaking did not make any change in whether discontinuances of stations or branches can be appealed to the Commission, which is governed by statute.<sup>30</sup> Despite the Commission’s opposing view as to the scope of 39 U.S.C. § 404(d)(5) appeal rights, the final rule went so far as to introduce an explicit recognition that the Postal Service may, in its discretion, decline to challenge the Commission’s jurisdiction in certain (or even, if it chooses, all) cases, in contrast with its previous practice of asserting jurisdictional defenses in all cases.<sup>31</sup>

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<sup>28</sup> *Id.* at 76-77. The draft report notes that the changes became the subject of a complaint filed with the Commission by postmasters and their representative organizations. However, this complaint was recently dismissed by the Commission. Order No. 797, Order Dismissing Complaint, PRC Docket No. C2011-3 (August 11, 2011).

<sup>29</sup> Draft Report at 76.

<sup>30</sup> United States Postal Serv., “Post Office Organization and Administration: Establishment, Classification, and Discontinuance,” 76 Fed. Reg. 41413, 41414-41415 (July 14, 2011).

<sup>31</sup> In a related section, the draft report takes up the Commission’s opinion that 39 U.S.C. § 404(d) was meant to apply to stations and branches as well as to Post Offices. The Commission’s appeal to “plain meaning” obscures more than a century of legislative history and case law to the effect that Congress understood and intended the distinction between Post Offices, which are subject to 39 U.S.C. § 404(d), and stations and branches, which are not. The Commission has never offered a detailed legal justification for its view, in contrast with the Postal Service’s extensive textual and historical analysis as to Congress’s intent. See *generally* Comments of United States Postal Service Regarding Jurisdiction Under (Current) Section 404(d), PRC Docket No. A2010-3 (April 19, 2010).

#### **4. Product Management**

##### **a. New Market Dominant Classes**

The draft report states that "the PAEA is silent as to whether new classes of mail can be added," concludes that this silence "limits the Postal Service's flexibility," and recommends that the statute be amended to provide explicit authority.<sup>32</sup> The Postal Service disagrees with the Commission's conclusion that the PAEA limits the flexibility of the Postal Service to add new classes of mail. To the contrary, existing law does not preclude the creation of a new mail class, nor is it clear that the PAEA's price cap could not accommodate new mail classes through the exercise of administrative discretion. Thus, while Congress may wish to clarify explicitly the Postal Service's authority to create new market dominant mail classes, the Postal Service does not believe that creating new classes of mail is precluded by the PAEA.

##### **b. Nonpostal Services**

Congress should give the Postal Service measured authority to engage in new revenue-generating activities not authorized under current law, in order to seek new sources of revenue consistent with the public interest and the needs of the marketplace. If the Postal Service is to take full advantage of additional revenue opportunities, the regulatory standards of the PAEA, which are designed to disfavor nonpostal services, will be a poor fit. The Postal Service supports the provisions for nonpostal services contained in Senator Carper's bill,<sup>33</sup> which do

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<sup>32</sup> Draft Report at 41.

<sup>33</sup> S. 1010, § 304. Bills by Representatives Connolly (H.R. 1262) and Issa (H.R. 2309) would also allow the Postal Service to offer nonpostal services under certain conditions.

not impose self-defeating regulatory restraints on authority intended to encourage the appropriate development of such services.

**c. Negotiated Service Agreements**

Under the PAEA, the Postal Service has entered into hundreds of agreements with mailers for competitive services, a level of activity that would not have been possible under the negotiated service agreement rules applicable under the PRA. As the Commission observes, the streamlined oversight of the NSA process is laudable; however, the process could be enhanced by having after-the-fact review and certainty in the form of a statutory time limit on Commission review of NSAs.

In particular, because in many instances the Commission treats a market-dominant or competitive contract as being a separate product, it conducts a review under 39 U.S.C. § 3642 to determine the proper categorization (or to confirm the Postal Service's designation) of that contract as market dominant or competitive. The proper categorization of a contract rate that represents a discount off of a generally applicable rate is self-evident, however. Therefore, the conduct of a proceeding that purports to decide that issue is unnecessary, and negatively affects the Postal Service's speed-to-market in offering customized prices and services to mailers. The uncertainty of the regulatory process and the implementation date inhibits the Postal Service's ability to compete effectively with private delivery firms that can offer contract rates with greater certainty and speed. The results have a particular impact on the Postal Service's ability to create new solutions for postal customers, as the Commission

subjects the first contract of a given type to the indefinite Section 3642 process. At the very least, there should be a time limit on any review of this type. Moreover, given the highly competitive, time-sensitive market for customized shipping solutions, regulatory review should be made after-the-fact, as proposed in the bill introduced by Representative Issa.<sup>34</sup>

In addition, for other, non-contract-based product changes that implicate Section 3642, the Commission is not subject to any statutory deadline for reaching a final decision. Even simple changes under that provision take months to accomplish. The lack of a time limit on these proceedings is inconsistent with the fact that the PAEA placed time limits on nearly every other proceeding that the Commission conducts. The Postal Service therefore proposes to place a time limit on any review of new market dominant products and new competitive products of general applicability. Senator Carper's bill would set such time limits.<sup>35</sup>

#### **d. Market Tests**

The Postal Service supports the Commission's recommendation for raising the maximum revenue limitation on experimental market test products. This additional authority to utilize the market test procedures can only enhance the Postal Service's ability to improve its financial condition.

### **5. Service Performance**

Service performance reporting has proven to be one regulatory area where an expressly limited statutory obligation has been expanded in both

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<sup>34</sup> H.R. 2309, §§ 404-405. Representative Issa's bill would require any review to be after-the-fact and completed within five working days.

<sup>35</sup> S. 1010, § 303.

breadth and depth, requiring significant compliance costs. The Commission's rules governing the Postal Service's reporting of service performance, codified at 39 C.F.R. Part 3055, imposed challenging and burdensome service performance reporting beyond the requirements of the PAEA.<sup>36</sup> The incremental benefits of the reporting requirements are outweighed by the associated administrative burdens, which is inconsistent with Congressional concern for balance in this regard.

While the PAEA simply mandates annual reporting, and nowhere establishes or suggests that the Postal Service must collect and file additional service performance information with the Commission,<sup>37</sup> the Commission's rules require quarterly reporting down to the individual district level. This action has resulted in additional cost, administrative burden, and delay in implementation for the Postal Service. Although the Postal Service offered in its 2008 Service Performance Measurement plan to file quarterly, *national*-level reports for each product class in the interest of transparency and facilitating Commission oversight, this offer was based on current capabilities and expectations that significant additional cost would not be incurred. Indeed, the Postal Service had already established a practice of posting such quarterly reports on its public website. The Commission took this offer, however, as an invitation to require quarterly reporting at a far more detailed level than the Postal Service's systems and finances were prepared to support, notwithstanding the Postal Service's

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<sup>36</sup> Order No. 465, Order Establishing Final Rules Concerning Periodic Reporting of Service Performance Measurements and Customer Satisfaction, PRC Docket No. RM2009-11 (May 25, 2010).

<sup>37</sup> 39 U.S.C. § 3652(a)(2)(B)(i).

objections about cost, lack of express statutory authority, and proportionality.<sup>38</sup>

To the extent the Commission has expanded 39 U.S.C. § 3652, which concerns annual reporting, into a justification for quarterly reporting, Congress should expressly instruct the Commission to limit its reporting rules to the annual reporting required by the PAEA.

The Commission took a similar approach in requiring the periodic reporting of matters relating to the Postal Service's operational performance generally, such as acceptance and delivery point statistics, wait-time-in-line data for retail customers, and customer survey results.<sup>39</sup> Such statistics may be generated occasionally or regularly for internal management purposes, but require additional administrative effort to develop into a publicly reportable form. Postal statutes do not authorize the Commission to monitor such network-wide operational statistics, and such statistics are not direct indicators of universal service, quality of service, or customer satisfaction, general statutory references to which the Commission cited to justify its new requirements. As noted in two Commissioners' concurring opinion, such information is not tied to any particular products' performance, which is what Title 39 charges the Commission to evaluate, and "may place an unnecessary burden on the Postal Service at a time when it has limited resources."<sup>40</sup>

Moreover, the Postal Service sees no need for clarification of the current statutory language regarding changes to service standards, 39 U.S.C. § 3691(a),

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<sup>38</sup> United States Postal Service Comments in Response to Order No. 292, PRC Docket No. RM2009-11 (November 2, 2009), at 15-16; S. REP. NO. 108-318, at 19 (2004).

<sup>39</sup> Order No. 465 at 52-57.

<sup>40</sup> *Id.* at 62-63 (Concurring Opinion of Commissioner Dan G. Blair and Vice Chairman Tony L. Hammond).

as the Commission recommends. The Postal Service has not objected to engaging in such consultations thus far.

#### **6. State Department Comments**

The Postal Service largely agrees with the July 6, 2011, comments of the Department of State, which are appended to the draft report. In particular, the Postal Service supports the Department of State's (State's) proposal to define the phrase "agency of a foreign government" for purposes of a requirement to file with State and the Commission commercial or operational contracts with such entities. 39 U.S.C. § 407(d). To the extent that an explicit definition would lend clarity, however, the definition proposed by the Department of State is overly broad and would be more burdensome than is the present practice for all parties involved, without appreciably furthering the underlying oversight interests of the Commission or State. The Department of State proposes defining the phrase to mean "*any entity in which a foreign state holds an interest, either directly or indirectly.*" If adopted, this definition would result in a need to file any commercial or operational contract with, for example, a domestic transportation provider in which a minority stake is held by a bank, a single share of which is held by a hedge fund in which a foreign sovereign wealth fund owns a single share. While this may seem to be a strained example, the Postal Service can also point to an actual example of a large mail consolidating company operating in the United States that is partly owned by a foreign postal operator that is owned, in turn, by its national government. In this case, the commercial contract for discounted mail rates for large volumes of presorted mail would have to be filed with the

Department of State and the Commission for transparency purposes under 39 U.S.C. § 407(d). This requirement does not appear to be an outcome anticipated by Congress, because such contracts must already be filed with the Commission by virtue of them being contracts establishing competitive commercial rates for postal services. Yet the Department of State's proposed definition would trigger the transparency filing requirement for such an agreement.

The Postal Service believes that the section 407(d) filing requirement is meant to ensure that contracts the Postal Service forms with foreign government entities acting as agents for the government should be disclosed to the Commission and the Department of State. To illustrate the appropriate distinction, one might contrast the manner in which the U.S. government would recognize its own agencies' activities, on the one hand, with those of companies in which the U.S. government owns an interest, such as General Motors Corporation, on the other hand. It is unlikely that the United States government would recognize General Motors Corporation as an agency of the U.S. government, despite the fact that its ownership interest in General Motors would meet State's own definition if it were applied reciprocally.

A more workable approach would be to adopt a definition that is focused more specifically on examination of commercial and operational contracts with entities wholly or partly owned by a foreign government and which operate in a governmental rather than commercial capacity. Indicators of whether an entity is operating in a governmental rather than commercial capacity might be the

domestic tax treatment received by the entity, whether it is operating under an exclusive license issued by the government, and whether the entity is established by the laws of a national government. It bears noting that neither the affected agencies nor the general public has expressed dissatisfaction with the level of transparency or oversight exercised to date under 39 U.S.C. § 407(d), notwithstanding the lack of a clear statutory definition. This suggests that the Postal Service's current practice, which is to file those commercial or operational agreements that it forms with parties in which a foreign government holds a direct and controlling ownership interest, is more than adequate, and that clarification of the definition should only be adopted to fit the requirement more narrowly to the need for transparency.

### **III. CONCLUSION**

The Postal Service's dire financial condition puts in peril its ability to provide universal service to the nation. Significant revisions to the PAEA are needed to enable the Postal Service to restore itself to financial solvency. Improving the Postal Service's financial stability in both the short-term and the long-term requires more comprehensive changes than are discussed in the Commission's draft report. The Postal Service and other stakeholders would benefit from the Commission's views on the ability of current law to produce long-term sustainability for the Postal Service and what changes are necessary to ensure the continued provision of universal service.



**United States Department of State**

*Washington, D.C. 20520*

Ruth Y. Goldway, Chairman  
Postal Regulatory Commission  
Office of Public Affairs and Government Relations  
901 New York Avenue NW  
Washington, DC 20268-0001

July 6, 2011

Dear Ms. Goldway:

This is in response to the Commission's invitation for comments on the operation of the amendments made by the Postal Accountability and Enhancement Act of 2006 (the PAEA) and for recommendations for legislation or other measures necessary to improve the effectiveness or efficiency of the postal laws of the United States. We appreciate the opportunity to provide these comments and recommendations, and we hope that they are useful to the Commission in its review process.

The PAEA made significant changes to former section 407 of the Postal Reorganization Act, as amended, which concerns international postal arrangements. In our experience with the amendments thus far, there have been few difficulties that call for legislative or other improvements. Interagency coordination as led by the Department of State on the formulation, coordination, and oversight of foreign policy related to international postal services and other international delivery services has been relatively smooth and effective within the framework provided by the PAEA.

We note, however, a few areas within which some improvements could be made. First, although section 407(d) is clear in its requirement that a copy of a commercial contract between the United States Postal Service (USPS or Postal Service) and an agency of a foreign government must be filed with the Department of State and the Postal Regulatory Commission not later than the effective date of such contract, whether a postal operator is considered an "agency of a foreign government" is a question for which the PAEA offers little guidance to answer. For the sake of clarity, we believe that a minor legislative amendment could be

made to provide the needed guidance and eliminate any disagreement about the application of this provision to the Postal Service in its commercial capacity.

Our understanding is that when an agency of a foreign government acts in a commercial capacity, it may lose entitlement to the protection of the Foreign Sovereign Immunities Act. Under these circumstances, it is in the interest of the U.S. government to have notice that a foreign government is engaging in such commercial activity. Thus, receiving copies of contracts memorializing these arrangements is of benefit to the U.S. government. It should be clear, though, that not all commercial contracts entered into by the USPS with foreign postal operators are subject to this requirement, only those entered into with an “agency of a foreign government.” Therefore, we recommend that a specific definition of “agency of a foreign government” be included in the language of section 407(d) of title 39.

Another legislative improvement that we recommend involves the funding of the Department of State’s activities under section 407 of title 39 of the U.S. Code. Since amendments made to section 407 through the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, dated October 21, 1998, the Postal Service has been required to allocate funds for these activities to the Department of State as are “reasonable, documented and auditable.” The Department of State has never sought funding for all of the expenses associated with carrying out its responsibilities under section 407. We note that funding for the activities of the Office of the Inspector General and the Postal Regulatory Commission are included in the annual budget that the Postal Service transmits to Congress under section 1105 of title 31, as required by section 2009 of title 39.

In the interest of clarity and consistency, we believe that amending section 2009 of title 39 to include the funds allocated to the Department of State for its activities related to section 407 would be appropriate. Including the funding for the Department of State’s activities related to international postal arrangements in the Postal Service’s annual budget transmitted to Congress would increase transparency and better enable the Postal Service, Congress, and other interested parties to identify quickly the support funds that the Postal Service is required to expend beyond those which are necessary to support its own infrastructure.

Including the recommended language in section 2009 would also make it more likely that anyone reviewing the laws related to the Postal Service would learn that the activities of the Department of State related to international postal and other international delivery services are supported through postal revenue, not the tax dollars that generally support the Department's activities.

We consulted with other agencies concerning any recommendations or comments that they might like to make, and we received none. Our recommended amendments to the mentioned sections of title 39 are enclosed. We appreciate the opportunity to have our recommendations included in your report and encourage you to contact us if you have any questions or concerns about them.

Sincerely,

A handwritten signature in blue ink, appearing to read "Dean Pittman". The signature is fluid and cursive, with a large initial "D" and a long horizontal stroke at the end.

Dean Pittman  
Principal Deputy Assistant Secretary of State  
Bureau of International Organization Affairs

Enclosure: as stated

Add subsection (f) to section 407 to read as follows:

(f) The Postal Service shall allocate to the Department of State from any funds available to the Postal Service such sums as may be necessary for the Department of State to carry out the activities of Section 407 of title 39 of the United States Code. To facilitate the allocation and transfer of the funds, by August 1 the Department of State shall present its request for the next fiscal year's expenses, which shall be reasonable and auditable, to the Postal Service. The Postal Service shall make the requested funds available for use by the Department of State not later than the first day of the fiscal year for which they are requested. Funds unused at the end of the fiscal year may be allocated to satisfy the next fiscal year request.

Amend section 2009 as follows:

. . . The budget program shall also include separate statements of the amounts which (1) the Postal Service requests to be appropriated under subsections (b) and (c) of section 2401, (2) the Office of Inspector General of the United States Postal Service requests to be appropriated, out of the Postal Service Fund, under section 8G(f) of the Inspector General Act of 1978, (3) the Postal Regulatory Commission requests to be appropriated, out of the Postal Service Fund, under section 504 (d) of this title, and (4) the Department of State requests to be allocated to it, from any funds available to the Postal Service, under section 407 (f) of this title. The President shall include these amounts, with his recommendations but without revision, in the budget transmitted to Congress under section 1105 of title 31.

Add new section 407(d)(3) as follows:

(3) In this subsection, "agency of a foreign government" means any entity in which a foreign state holds an interest, either directly or indirectly.

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**Clearance:**

**A/DAS: Julie Connor – OKay**

**IO/GS: Thatcher Scharpf – Okay**

**IO/GS: Dennis Delehanty – Okay**

**L/UNA: Gabriel Swiney – Okay**