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Mr. Dan Blair
Chairman
Postal Regulatory Commission
901 New York Ave., NW
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Dear Mr. Blair:

The Postal Regulatory Commission's *Notice and Order Providing an Opportunity to Comment* of April 18, 2008 invites public comments on the Commission's report to the President and Congress on universal postal service and the postal monopoly in the United States, as required in Section 702 of the Postal Accountability and Enhancement Act of 2006 (PAEA). As a professional economist, academic, and author of numerous studies on postal issues, I am writing to submit comments pursuant to this Notice. I believe that this report provides an excellent opportunity to offer a new vision for postal policy in the United States. My comments are consequently broad in scope.

There are several specific topics enumerated in the Order on which I would like to comment:

Topic No. 9: Methods of Calculating the Cost of the Universal Service Obligation and Postal and Mail Box Monopolies

I simply note under this topic that the nature and scope of the universal service obligation is currently undefined. As the Discussion Memorandum to the Notice makes clear, the notion of universal service has not been defined in either the PAEA or in the United States Code. It is obviously difficult to assign costs to an undefined obligation. However, the Commission may wish to assign costs assuming various plausible alternative scenarios for the USO, and borrow from the experience in other countries in defining it.

I would also urge a "bottom up" approach to defining the USO. That is, the approach to defining the USO should be consumer driven. Relevant questions become: what type of universal service do consumers find most valuable? What type of services are they willing to pay for? How frequently do consumers want those delivery services? This is in contrast to a "top-down" approach that would essentially define the USO centrally without consideration of the value actually received by consumers.

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Topic No. 10: The Implications of the Universal Service Obligation for the Postal Monopoly

On page 10, the Order states, "In addressing this topic, Commentators should discuss how their conception of the universal service obligation would affect the need for, and parameters of, the postal monopoly and mailbox monopoly." I first address the delivery monopoly.

The Delivery Monopoly

One obvious question is why a universal service obligation, however defined, and the delivery monopoly are linked. The traditional argument is that a government monopoly over letter delivery will ensure that profits from dense, lucrative urban routes can cross-subsidize money-losing rural routes, whereas private competitors might not provide delivery to remote areas. This rationale for a government-enforced delivery monopoly is questionable, for the following reasons:

Competition has been introduced in other network industries and rural service has been maintained

There were similar concerns about the maintenance of service to small and rural communities in the debate over airline deregulation (under regulation, firms were required to serve certain city pairs). Indeed, Congress was sufficiently concerned about the effects of introducing competition into the airline market that it created the Essential Air Service Program. That program would provide subsidies to carriers to ensure at least two flights per day for 150 small communities.

Studies indicate, however, that Congress need not have worried. The frequency of flights was not reduced as a result of airline deregulation. In fact, daily departures increased significantly at large and medium hub airports, moderately at small hub airports, and slightly at nonhub airports (Morrison and Winston 1997). However, airline deregulation accelerated the use of the hub-and-spoke system, which results in a substantial increase in the number of available connections. The number of daily departures thus understates the variety of alternative destinations deregulation actually created for small town travelers. Morrison and Winston (1986) estimated that deregulation increased the number of feasible flight alternatives to travelers by 20 to 30 percent on small and nonhub routes. They also found that deregulation increased the number of cities served nonstop at all airports significantly. Numerous studies also find that customers overall benefited through substantially lower airfares.

A further effect of airline deregulation – one that was largely unexpected -- was the adoption of many different sizes and types of aircraft. This allowed firms to more profitably serve smaller cities than under regulation. This also illustrates an important and often underappreciated effect of competition: *it drives innovation*, which causes firms to

adapt in unforeseen ways. This would also likely be the case in providing delivery service to rural areas.

There are many studies indicating that the deregulation of other network industries, such as trucking and railroads, created massive social benefits. Clifford Winston of the Brookings Institution summarized these effects, and found that they created between $35.8 billion and $46.2 billion (in 1990 dollars) of benefits for society, which includes both consumers and producers (Winston 1993, Table 6, p. 1284). There are also follow-up studies suggesting that firms adjusted to competition in a number of innovative, salutary ways. For example, Winston (1998, p. 95-6) states, "The intensified competition resulting from deregulation causes firms to make innovations in marketing, operations, technology, and governance that enable them to become more efficient, improve their service quality, introduce new products and services, and become more responsive to consumer's preferences."

One may suppose that industries are so different that such social benefits would not be forthcoming from competition in postal services. Winston, however, concludes by stating that:

> Some policymakers and economists appear reluctant to draw generalizations from the U.S. experience with deregulation over the last two decades. Industries, it is said, are different: they have different technologies, entry requirements, and so on. That deregulation works in one industry does not imply it will work in others.
>
> This paper suggests, however, that industries are likely to behave quite similarly when it comes to adjusting to deregulation, and that their adjustment, while time-consuming, will raise consumer welfare – significantly even at first, and increasingly over time. Markets will become more competitive. Firms will develop innovations to become more efficient and more responsive to consumers. The benefits to society will grow as the adjustment continues. (p. 108).

The industries studied here all have a network structure similar to postal services. The experience with deregulation of these industries suggests that concerns about service to small communities will not be sacrificed by introducing competition, and that society stands to gain vast social benefits. At an absolute minimum, experience suggests that one must be quite skeptical of claims that increased competition will undercut the geographic scope of a network industry.

A monopoly is unnecessary to ensure universal service

A second concern related to Topic No. 10 is the conflation of the USO and with the need for a delivery monopoly. It is critical to separate conceptually the issues of (i) the desire to subsidize postal service to certain areas or communities from (ii) the most efficient way to deliver those subsidies. The policy decision to subsidize postal delivery to certain areas *does not imply* that a delivery monopoly is necessary or desirable, or the best way to provide that subsidy. Indeed, given the high cost associated with a government-

enforced monopoly (i.e. a restriction on entry), a monopoly on delivery service may be the worst way to deliver such a subsidy.

Rather, the government could easily allow, and indeed preserve, competition in delivery service (and thus realize competition's benefits for both customers and firms) but still guarantee universal service. This can be accomplished via contracting with private firms to provide service to areas or communities that would be underserved in a competitive market. Indeed, in a study of the services best provided by government versus the private sector, the eminent Harvard economist Andre Shleifer held up the Postal Service as a canonical example of how contracting can address concerns about service to rural areas:

> A common argument for government ownership of the postal service is to enable the government to force the delivery of mail to sparsely populated areas, where it would be unprofitable to deliver it privately. From a contractual perspective, this argument is weak. The government can always bind private companies that compete for a mail delivery concession to go wherever the government wants, or it can alternatively regulate those companies when entry is free. It cannot be so difficult to write the appropriate contract or regulation; after all, the government now tells the U.S. Postal Service where it wants the mail to be delivered. (Shleifer 1998, p. 136)

There are many ways that universal service could be preserved in the presence of competition. One is to use regulation to require private, competitive firms to serve certain areas, effectively imposing an urban-rural cross subsidy on those firms (but see discussion in next section). It may be preferable however to deliver any desired subsidy by granting a fixed-term concession to a private delivery firm. This approach preserves competition, since the concession would be awarded based on a competitive bidding process, where firms bid based on the *lowest acceptable subsidy* to provide a pre-determined level of delivery service to a certain area or community. This approach would ensure that the cost of delivering the subsidy is minimized, and has been used in other industries and countries to provide socially desirable but unprofitable services (such as money-losing toll roads) in a competitive manner. Regardless of the mechanism used, the key insight is that *the desire to provide a subsidy for certain level of service to certain areas does not imply that a delivery monopoly is necessary.*

Statistical evidence indicates that any subsidy to rural areas is small or nonexistent

Statistical studies suggest that, contrary to intuition, there is no rural-urban cross subsidy in the United States (Cohen, Robinson, Waller and Xenakis, 2002, p. 17). As a group, rural routes are about as profitable for the Postal Service as are urban routes. This is because rural letter carriers frequently use roadside delivery (where the letter carrier drives along a route) while city carriers are more likely to use park-and-loop delivery (where the letter carrier parks a vehicle and walks a route, then returning to the vehicle). Roadside delivery is often more efficient that park-and-loop (Bernard et al, 2002), mitigating the effects of urban density on delivery cost. Cohen, Ferguson and Xenakis (1993) conclude by stating, "It is likely that, if the universal service requirement were eliminated, even the most sparsely populated rural areas would receive service."

Therefore, even if one believed that a enforced delivery monopoly were the best way to ensure a urban-rural cross subsidy, the lack of money-losing rural routes implies that the monopoly is unnecessary.

All routes could easily become profitable if bulk mailers were charged route-dependent rates

If one were concerned about lack of service on certain routes due to losses, delivery firms facing competition could easily make all routes profitable if they were allowed to charge route-dependent rates to bulk mailers. This does not mean abandoning geographically uniform stamp prices because postage for bulk mail is calculated by computers. Bulk mail postage could thus easily be adjusted to reflect the costs of a particular route, making all routes profitable.

There is historical precedent for non-uniform rates: postal rates for local and long-distance letters were not equal until 1885 and diverged again in 1932. They were set equal in 1944. Again, the key insight is that the delivery monopoly is unnecessary to ensure universal service.

All routes could be made profitable by adjusting delivery frequency

Even if one believed that certain routes were unprofitable under current delivery frequency, a firm could easily reduce the delivery frequency on certain routes, perhaps to four or five days per week, until costs were reduced enough to make the routes profitable. The routes need not be abandoned altogether. Again there is a precedent, as twice-daily delivery in cities was eliminated in the early 1950s. Also, see my discussion above on how the level of service should be consumer driven.

Evidence indicates that mail delivery firms facing competition, like firms in other network industries, maintain universal service

Maintaining a universal network enhances service quality. Private delivery firms facing competition (i.e. without a monopoly) thus have a business incentive to maintain a universal delivery network even if some routes lose money. The value of a postal network is directly related to the number of addresses served, as firms want to say they "go anywhere." This is true for services outside the delivery monopoly, such as parcel and express services. Experience now suggests that a monopoly is unnecessary to maintain universal service even in letter delivery. As my discussion below indicates, New Zealand and Sweden have eliminated their postal monopolies and rural delivery has been maintained.

Summary

This analysis of Topic No. 10 indicates that the delivery monopoly is unnecessary for the provision of universal service. As the evidence from deregulation of other network industries makes clear, enormous social benefits are likely to be realized from the

introduction of competition. The PAEA defined the delivery monopoly area reserved for the Postal Service as six times the current stamp price. This reserved area multiple should be reduced over time to introduce more competition into the delivery of US postal services. The delivery monopoly should then be eliminated entirely. This would allow private competitors to enter the market and allow the benefits of market competition, now so clear from the deregulation of other network industries, to be realized.

The Mailbox Monopoly

There is no policy rationale for retaining the mailbox monopoly

I now address the second monopoly mentioned on page 10 of the Notice, which is the mailbox monopoly. The policy case for repeal of the mailbox monopoly is perhaps even more compelling. This monopoly generates no social benefits, yet creates substantial social costs. Notably, unlike the delivery monopoly, it has never been suggested that the mailbox monopoly is necessary to ensure universal service, nor could it be. The United States is the only country in the world with a mailbox monopoly, yet other developed countries maintain universal service. Therefore, those opposed to the repeal of the mailbox monopoly bear the burden of explaining why mail delivery operates well in other countries that do not have such a monopoly.

This monopoly is sometimes defended on the basis of mail security, but again this has not been a problem in other countries without the monopoly. Moreover, private delivery companies in the United States that are not allowed to use the mailbox have strong reputations for security, such as FedEx and UPS. Those companies also have powerful market incentives to maintain the security of material they deliver.

Finally, the mailbox monopoly imposes social costs. For example, it means that homeowners must install separate boxes for the receipt of newspapers and other non-mail material. It also imposes costs on competitors, who must find other ways of reaching customers. Under antitrust law, it would likely be considered anticompetitive under the essentially facilities doctrine. That doctrine suggests that a monopolist engages in anti-competitive behavior by denying a competitor access to an essential or bottleneck facility. (See, for example, http://en.wikipedia.org/wiki/Essential_facilities_doctrine).

There is no policy rationale for retaining the mailbox monopoly, yet it creates social costs. A forward-looking postal policy would repeal this monopoly as well.

Topic No. 11: Universal Service, the Universal Service Obligation, and the Postal Monopoly in Other Countries

I would like to offer observations from the liberalization experience in two other countries, New Zealand and Sweden, to help address this topic. This experience suggests

that competition can be introduced, and has been introduced, but service to small and rural communities has been maintained.

New Zealand

In 1987, New Zealand corporatized the New Zealand Post Office, renaming it New Zealand Post, and giving it attendant commercial freedoms and obligations. New Zealand limited the Post's monopoly to letters weighing 500 grams (1.1 pounds) or less and transported for NZ$1.75 (then about U.S. $0.74) or less. The government subsidy to the Post Office was to terminate after one year. In February 1988, New Zealand Post, facing the prospect of competition and losing its subsidy, closed a third of its post offices and increased its annual rural delivery fee. New Zealand Post's small post offices actually did very little postal business. The majority of the business was related to postal banking and telecommunications (banking and telecommunications services were combined in New Zealand as in many European countries). The Post Office's closure of these offices was a decision not to subsidize these other services any longer. Following public outcry, a Parliamentary investigation concluded that the problem stemmed only from the maintenance of rural banking services. Parliament suggested non-postal remedies to maintain banking services.

The Postal Service Amendment of 1990 required that, over a two-year period, the price limit would be reduced further to NZ$0.80 (then about US$0.34) and the weight limit to 200 grams (U.S. Postal Service, 2002, H-20). The Postal Services Act of 1998 then abolished the postal monopoly altogether. But the government maintained a "Deed of Understanding" with New Zealand Post under which it had to maintain a specified number of post offices, to keep the stamp price below NZ$0.45, and not to introduce a rural service fee. Under the Deed, New Zealand Post must provide 95 percent of households with letter delivery service six days per week, 99.88 percent of households with service five or six days per week, and the rest at least one to four days per week (U.S. Postal Service, 2000, E5).

New Zealand Post remains government-owned, but it has introduced new services and improved its efficiency. From corporatization in 1987 through 1995, although it had 30 percent more mail to deliver, it had reduced its workforce by 40 percent, and doubled its labor productivity. It did so without major labor strife, mainly through attrition, early retirement, various incentive packages, and the use of part-time and shift work (U.S. Postal Service, 2002, H-23). The real price of a letter fell by almost 30 percent between 1987 and 1995, and New Zealand Post *reduced* the basic stamp price in 1995 from NZ$ 0.45 to NZ$ 0.40. New Zealand Post has modernized its transportation network, its technology, and its retail facilities. There have been no concerns about the maintenance of universal service in New Zealand. There has also been substantial entry in New Zealand; fifty new postal companies registered between 1998 and 2004. (see http://www.med.govt.nz/pbt/post_pol/register/index.html).

Sweden

The Swedish government eliminated its postal monopoly in 1993 rather than suppress CityMail, a new entrant in Stockholm. CityMail provided low-cost delivery of computer-generated bulk mail (which includes invoices, statements, and personalized advertising mail) in Stockholm. It then expanded into Malmo, Gotenburg and surrounding areas. The Swedish Post Office supported the elimination of its monopoly because it realized that without de-monopolization it would not receive the commercial flexibility necessary to compete effectively.

Following de-monopolization, the Swedish Post Office was corporatized through the Postal Services Act of 1993. The new firm, named Sweden Post, was a limited liability company with all shares owned by the government. The government contracted with Sweden Post to provide universal service. The Act required licensing for all postal operators, to be administered by an independent regulator. The regulator may attach conditions to a license, including a requirement to provide universal service.

As in New Zealand, Sweden Post responded to competition by increasing efficiency through workforce reductions, mainly though attrition, and without strikes (U.S. Postal Service, 2002, H-2). Sweden has about 50 licensed postal operators, but the main competitor for Sweden Post is still CityMail. CityMail had about 7 percent of the delivery market in 2003, up from 3 percent in 1997 (Cohen et al., 2005). Sweden Post nevertheless retained a large market share after de-monopolization. There are no concerns about the adequacy of universal service in Sweden.

Summary

If adopted, the suggestions I have outlined here would help the Postal Service to benefit from the disciplinary effects of market competition, and would preserve basic delivery service to all areas and communities. They are consistent with what has taken place in other countries. I hope you find these comments helpful.

Sincerely,

R. Richard Geddes

Enc.

Attachment:
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