



The Honorable Edward J. Gleiman

Parcel Shippers Association Speech

April 20, 1999

Thank you for inviting me.

A highly regarded operative on the Washington scene, fellow by the name of Tim May, is reported to have once said that “being the managing partner in a law firm is like being the only fire hydrant in a hundred dog town.” There have been days during my tenure at the PRC when I knew exactly what he meant. Today, I know, is not one of those days. And, inasmuch as I may be the first Postal Rate Commission member to participate in a Parcel Shippers Association meeting--- as best anyone at the Commission can recall--- let me say that it is an honor and “almost” a pleasure to be with you today. I say “almost” because you now have the good fortune to have Pierce Myers as your Executive Vice President, and I must now write my own speeches. If I say something today that you do not like, it is his fault. Surely, he would not have let me say whatever it is that may offend you!

Let me tell you a little story that puts anything I say today in the proper perspective:

This fellow is flying a hot air balloon, and he suddenly realizes he is lost. He reduces height and yells to a man he spots down on the ground.

“Excuse me, can you tell me where I am?”

“Sure,” the man yells back, “you’re in a hot air balloon about 30 feet above this field.”

“You must work in information technology,” says the balloonist.

“I do,” replies the man “but how did you know?”

“Well,” yells the balloonist, “everything you told me is technically correct, but it’s of no use to anyone.”

The man on the ground thinks for a moment and yells back “you must work in management.”

“Why yes, I do,” replies the balloonist proudly, “but how did you know?”

“Well,” says the man on the ground “you don’t know where you are or where you are going, but you expect me to be able to help. You’re in the same position you were in before we met, but now it’s my fault!”

We all know that the economics of residential parcel delivery is different from commercial delivery. One has only to stand in the lobby of the PRC’s office building at 1333 H Street, NW to understand this point. The UPS driver brings in a dolly load of parcels addressed to several offices in the building. The additional cost of delivering an extra parcel to one of these offices is small. As a matter of fact, even if the driver delivers a parcel to an office in the building that is not among his regulars, the additional cost is small. This is what is called economies of scale. Moreover, the offices he delivers to are nearly always open and, if not, a parcel can be left with the 24-hour front desk. The driver seldom must make a second delivery attempt for a commercial parcel delivery.

Let’s compare this to UPS residential delivery. I frequently see UPS trucks in the neighborhood where I live. The truck can travel several blocks before making a stop. When it does, you can bet that only one parcel will be delivered to that house. Frequently no one is home and, so, another delivery attempt may have to be made. There are no economies of scale here.

Now, let’s talk about route time or driving time. The amount of time spent driving between commercial stops is small. Driving time per commercial parcel delivered is smaller yet. The opposite is true for residential delivery. Driving time between residential stops is large, and driving time per parcel is much larger in residential delivery. UPS surcharges residential delivery because it costs UPS more than commercial delivery.

The economics of residential delivery for the Postal Service, however, are very different. Because the volume of First-Class and Standard A letters and flats is so

large, the Postal Service enjoys tremendous economies of scale in both residential and commercial delivery. Also, the Postal Service has economies of scope which UPS does not have. Roughly speaking, economies of scope mean that two products can be produced together at less cost than each one separately.

Residential parcels tend to be small and can fit into a letter carrier's vehicle. The carrier can deliver parcels as a byproduct of delivering letters and flats. The situation is not the same for commercial parcels. They tend to be larger, and many letter carriers do not use vehicles in the central business district. Moreover, volumes of letters and flats delivered to businesses are quite large. For these reasons letter carriers frequently deliver only small parcels in commercial areas. To deliver other parcels in those areas, the Postal Service frequently must operate special purpose parcel routes. Thus, the Postal Service does not enjoy economies of scope in commercial parcel delivery.

For these reasons, the Postal Service should have a comparative cost advantage in the delivery of residential parcels; whereas, UPS may have the advantage when it comes to delivering traditional commercial parcels. I say traditional here because of today's changing landscape with an ever growing number of home office-based businesses.

But there is more to the parcel business than just the cost of delivery. There is the cost of transportation and handling, and perhaps even more important, quality of service. Service, of course, includes speed and reliability, as well as proof of delivery, tracking and guarantees. In many of these aspects, the Postal Service suffers by comparison.

As we all know, the Postal Service has a monopoly in its core business. Monopolies are not known for efficiency or innovation. Although, I must say that together with suggestions from its customers (that's you) and, dare I say, from the Rate

Commission, the Postal Service has been more innovative in recent years. For example, the concept behind parcel classification reform, as I understand it, was to capitalize on the Postal Service's strengths and to minimize its weaknesses.

Classification reform should allow shippers of residential parcels (1) to bypass much of the relatively inefficient portion of the Postal Service's system and (2) exploit its letter mail monopoly, which confers strong scale and scope economies on parcel delivery. As a result, the Postal Service should become even more competitive in residential parcel delivery. This is good for you, good for the Postal Service, good for competition, and that's good for America. Who knows, in this era of strategic alliances, perhaps the USPS will enter into agreements with other parcel delivery firms who see an advantage in using the Service's residential delivery network.

I must tell you, though, that recent reports on the state of the Postal Service's finances are troubling in that much of the blame for the revenue shortfall relative to budget is being explained in terms of mailers moving their mail into discount categories---categories that produce less revenue per piece. Discounts are, of course, set on the premise that mailers will do work heretofore done by the Postal Service and "costs will be driven out of the system"; that is, out of the Service's cost base. The focus in these financial reports is on First Class and Standard A; however, the underlying principle applies to parcels as well. If finances are bleak because mailers are doing worksharing and/or presenting less costly mail, there is only one conclusion I can draw: The Postal Service is NOT capturing cost savings! This, my friends, does not bode well for the future. And, while I applaud PMG Henderson's recent efforts to get things back on an even keel by trimming Headquarters' costs, the real problem may be in implementation and operation of new systems in the field.

This brings me to the second issue that I would like to touch on today: The data collected by the Postal Service.

The Postal Service, GAO and the Rate Commission recently collaborated in monitoring a study on Postal Service data systems requested by Congressman McHugh. Overall the study found the statistical properties of the data systems to be quite acceptable. The study did not, however, examine what statisticians call nonsample error. These are errors which include incorrect recording of data, not recording data on the right thing, mistakes in tabulation, not using the best information in tabulations, faulty data collection plans, etc.

Clearly the identification and fixing of nonsample errors is important, and I hope a second study will be launched to examine nonsample errors and to determine ways to minimize them. I mention this here because the revision to parcel volumes and costs, which the Postal Service surfaced in January, was based on the discovery of a nonsample error.

As I understand it, the Postal Service changed its parcel post volume estimation procedure, starting with the first quarter RPW Report for FY 1999. The RPW has a sampling system, which samples mail at exit points in the postal system to estimate volume. It also has a bulk mail subsystem, which uses bulk mailing forms to estimate volume. Apparently the sampling system had been used to estimate permit parcel post volume. The statisticians at Postal Service Headquarters decided to see if those results matched the numbers from the bulk system. Voila, they found a discrepancy and, upon investigation, they decided that the bulk system furnished more reliable data.

I find it interesting that the Postal Service had what in effect was redundant systems to measure permit parcel post volumes. Before we condemn the Service for using the wrong system, we should appreciate the fact that there were two independent systems, which could be compared, and applaud the initiative postal officials took. The Service spends a lot of money collecting data, and it is this data which allows the many fine distinctions in cost that form the basis for the worksharing discounts that many of you utilize.

The U.S. Postal Service has far and away the richest, and some might say the most complex, classification system of the world's post offices. It is the data systems that support all the worksharing and other classification distinctions. Good data are important if our approach to classification is to work well. I think it is working well (but not perfectly). Mailers derive tremendous benefits from our complex system of rates and discounts. It has allowed the inflation adjusted price of mail to remain stable and even drop over time. Underlying this are the Postal Service data systems.

The adjustment in the Postal Service volumes revealed an additional 50 million pieces per year and \$125 million more in revenue. At Commission recommended rates, the effect of this additional volume would have raised the institutional cost coverage of parcel post from the recommended 108 percent to 126 percent.

While 108 percent coverage for parcel post was recommended by the Commission based on the information before it, no one could say what coverage would have been recommended if the new data on volumes and revenues had been available. If we had known about that volume, the Commission would have seen a much healthier and more competitive subclass, better able to shoulder institutional cost burden. Remember, the average coverage for all subclasses in R97-1 was 155 percent. Parcel post was set way, way below the average. Certainly the good news on volumes and revenues would have called for some increase from 108. Yes, a higher markup! Now hold on---don't start throwing things at me. Yes, a higher markup, BUT in all likelihood, lower rates!

How much of an increase in the markup; rates how much lower? No one, not even the Commissioners, could say without taking into account all the factors underlying the trade-offs that are inevitable. What we do know, however, is that better, more accurate data is a prerequisite to fair rates.

Now, if I could just mention briefly several other topics that may prove thought provoking and which depend on Postal Service data:

I have been asked by several people about the parcel post rate increases the Commission recommended in R97-1. In particular, I am asked why our increases for many mail subclasses were less than what the Postal Service proposed, but, for parcel post, the Commission recommended a 12.3 percent increase in the face of a requested 9 percent increase.

Let me explain. Postal costing concepts are complex. Some would say arcane. In the last rate case the Commission changed the Service's costing concepts in several respects. The Commission rejected the Service's econometric analysis of mail processing costs. As a consequence, the level of attributable costs stayed pretty much the same, whereas the Service had hoped to shift more of its costs to the institutional or overhead category. On the other hand, we modified the proposed distribution basis for attributable costs, which lowered attributable costs for parcels. (Doing so raised costs for many other subclasses.) The Commission also removed from the attributable column certain air transportation costs associated with Alaska — as we have in recent rate cases — and this also decreased parcel post costs. This move, by the way, created an odd set of alliances, which found the PRC and the PSA on one side and the USPS and UPS on the other. There were other adjustments to the Service's proposal. When all was said and done, the Commission's total parcel post attributable costs were about the same as the Postal Service's. That's where the Commission's judgment of the appropriate allocation of institutional costs enters the picture. The Service proposed a very low cost coverage for parcel post, 104 percent. The Commission considered this too low for a competitive subclass, and increased the coverage to 108 percent. This is the major reason the Commission's parcel post increase was greater than what the Service proposed.

Finally, a little something to whet your appetite for the future.

We know that bulk parcels (i.e., those that are drop shipped in quantity) cost less than single piece parcels. I am sure you would like to know if this fact would justify a new subclass for bulk parcel post. The Commission's criteria for establishing subclasses has been stated in several of its decisions. Its most definitive views on the subject were expressed in the MC95-1 reclassification case. There, as in other places, the Commission said that in order to create two subclasses out of an existing subclass, it would be important that the two groups of mail have significant cost differences. In addition, the Commission should have good reason for wanting to apply the noncost factors of 3622(b)(3) differently to the two groups. These factors include the concept of value of service, which is frequently taken to mean elasticity of demand, or the response of volume to changes in price. You know much better than I do whether single piece and bulk parcels have different elasticities of demand.

I want to be clear that I am not saying that if you demonstrate on the record that bulk and single piece parcels have different costs and have different elasticities of demand, then you have demonstrated that they should be separate subclasses. But I will say that this would be helpful to the cause.

The Commission would expect to have cost differences between single piece and bulk parcels, because one category involves worksharing while the other does not. Workshared mail simply costs the Postal Service less than nonworksharing mail---at least that's the premise that we operate under. However, we do not go around creating subclasses based on this kind of cost difference.

The question is: Are there intrinsic cost differences between the two types of mail, or can all the differences be explained in terms of the degree of worksharing? This would require analysis. Clearly the issue of subclass status for bulk parcel post would be controversial to say the least.

At this point, I think I'll raise my right hand. Let Tim May swear me in. And, try, to the best of my ability, to answer questions you may have.