

**Preparing the Postal Service's
Rate Structures for Competition:
A Study of How the United States Postal Service
Might Adjust to Increased Competitive Pressure¹**

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1. INTRODUCTION

In recent years, considerable attention has focused on increasing competition in the provision of postal services. The reasoning is that competitive pressure brings about productive efficiency, efficient price structures, product innovation, and the elimination of economic rents. Postal administrations, however, are often under constraints that limit their ability to respond to such pressure.

Consider the United States Postal Service. It is constrained by laws and regulations formulated by Congress over more than two centuries. This political process focused as much on social considerations as on the kinds of market forces that shape competitive outcomes. And once made, provisions have tended to remain. These observations apply, though in somewhat altered form, even since the

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Postal Reorganization Act of 1970. Specifically, that Act turned rate making over to an independent Postal Rate Commission, but it also specified a range of factors to which the Commission must give weight and it required that certain classification structures of the past be honored.³

This paper focuses on changes the United States Postal Service would make if it had the freedom to position itself to withstand competition in all of its markets. (Crew 1995) After such adjustment, it might become a sustainable monopoly. If this occurred, the Service's configuration would be that of a successful competitor and, at the same time, any benefits from having one provider would be retained. These benefits include economies of scale and joint production. No changes of any kind are advocated. Note that the extent of any changes that would be made is a measure of the extent of non-market choices that have been allowed by the protection currently provided.

Creating a competitive environment would involve, at a minimum, eliminating the Private Express Statutes⁴ and the mailbox rule.⁵ Absent these, some portions of the mail stream would attract

³ As discussed below, it required continuation of 5 preferred subclasses.

⁴ These statutes are laws that comprise the letter mail monopoly.

⁵ The mailbox rule specifies that no one other than the Postal Service (and the addressee) may put mail into the box. This rule is part of the United States Criminal Code. No other country has such a rule. Note that eliminating the rule is not a simple change and has a downside. In particular: 1) The Postal Service itself owns and maintains many of the boxes—specifically those known as “cluster” boxes. 2) Many owners of boxes, particularly those in apartment complexes and those secured by locks, do not want to open them to all parties. 3) The ability of the Postal Inspection Service, or similar replacement agency, to control mail fraud would be

the attention of competitors. The Postal Service would suffer financial losses. This could lead to a spiral of rate increases and further volume losses.

The Postal Service would be better off if it lowered selected rates and took back some of the lost volume. If it did this, some of its new competitors would be driven out of business, causing both investor losses and charges that the government should not be competing with private enterprise. Such a scenario is not desirable. A much better approach would be to allow the Postal Service to make adjustments first.

Accordingly, the setting of this paper is that all protection will be removed and that the Postal Service is given wide latitude to make its products and services as uncontestable as possible. And if it were found to be a sustainable monopoly, one could ask whether that situation would be better than the one that exists now. There are at least two reasons why it might. First, competitive configurations give superior, cost-based signals to buyers so that the value of the service received is greater. Second, the Postal Service would have to face real competitive threats at all times. In fact, some business at the margins would probably be lost. Therefore, the entire organization would sense on a regular basis that competitors stand ready to take its customers, and it would see some customers leaving. Such pressure might not satisfy those who envision a market with a number of active

reduced if general access to the boxes were allowed. And, many members of the general population favor the rule because it reduces the number of people who have

competitors, but having a number of active competitors is not always a viable option.

The next section discusses general guidelines for the paper. The third section identifies changes that the Postal Service would make immediately. Section four looks at how the range of postal products might change. It points to general directions and is not precise. The fifth section discusses worksharing and contracting, while the sixth deals with the general issue of cost recognition in rate design. It focuses to a considerable extent on weaknesses in the current state of knowledge. The seventh and eighth sections discuss costs by destination and by customer. Then the next two discuss inverse price caps and the benefits of having one government provider. A conclusion follows.

2. GENERAL GUIDE LINES

First, it is necessary to discuss the framework within which the Postal Service's adjustment process will be considered.

As noted above, relaxing the Private Express Statutes is the essential first step. Hiding under the Statutes, however, is a rule mandating that all bills, statements of account, and personal or handwritten correspondence, if mailed, must be mailed First Class (the MBMFC rule). To a much greater degree than is commonly recognized, this rule is critically important to the functioning of the Postal Service as it now exists. The MBMFC rule requires a substantial portion of the mail volume to be sent at high First-Class

legitimate reasons for accessing a residence. These problems could perhaps be

rates, instead of at the lower Standard-A rates, even though the senders may not value the high service levels or the special features of First Class.⁶ If the rule were eliminated, the Postal Service would lose a large portion of its revenue, immediately, with little or no reduction in cost, and rate adjustments would have to be made.

As an economic matter, it is possible that much of the MBMFC mail is high-demand mail, and thus that the rule segments the market according to demand. In order to continue benefiting from this split, the Postal Service might try to maintain it, even without the Statutes. But since rates based on content are seldom the outcome of competitive forces, such an effort would in all likelihood fail. What is important to understand is that the MBMFC rule is fundamental to First Class and Standard A as we know them, and eliminating it would unleash forces that would lead to a major restructuring, not to a minor adjustment.

In addition, it seems likely that the Postal Service would be prohibited from selling below incremental cost, would be required to preserve some form of universal service,⁷ and would be permitted to adjust its service levels. Also, the Postal Service would be allowed to grant volume discounts and to negotiate contract rates.

Another question concerns the most effective way to install a profit motive. In general, the outcome of effective competition is

overcome by licensing access to the mail box.

⁶ In addition to its high service levels, First Class offers free forwarding and is sealed (legally protected) against inspection. Standard A is deferrable, without these features, and has a lower rate.

expected to be a normal profit level, with the understanding that unusually efficient firms might achieve supra-normal profits for a time. One possibility would be to allow a portion of any profit to be used for performance bonuses to management, but there would be reason for concern if high and persistent profits resulted. Also, there would be concern if monopoly power allowed certain products to have excessive prices. In order to attenuate these concerns, it might be reasonable to place price caps on any *de facto* monopoly mail categories, particularly any used by small mailers with no alternatives.⁸

Within this set of rules, particularly if profits are allowed, the Postal Service would behave much like a profit-maximizing firm. Considerable attention would be paid to demand and to prices that could be charged successfully. In addition, one would expect a renewed interest in costs for narrow product categories, even for specific customers.⁹

If the Private Express Statutes were repealed, it is possible that Congress would also change the framework for labor negotiations, especially the no-strike rule and the requirement for binding arbitration when no agreement is reached through collective

⁷ The restriction would be that it must provide some reasonable level of service on seemingly reasonable terms to all recipients.

⁸ A regulator might well be required to administer any price caps, incremental-cost floors, or other restrictions.

⁹ Note that the effects of Postal Service adjustments could be substantial and widespread, not only on mailers who have invested heavily around the present structure of products and rates, but also on such competitors as newspapers. Some of these groups would strongly resist any changes.

bargaining. It might also lift the pay caps on management salaries. Even without such changes, the Postal Service could pursue regional wage differentials. For purposes of this paper, however, it is not necessary to specify a new labor environment. What is important is that labor negotiations take place within the framework of a situation where the loss of business to competitors is an everyday reality. If the Postal Service makes all feasible changes and the markets are found *not* to be contestable, it will be because the economies of scale and joint production, and the advantages of being an incumbent,¹⁰ are larger than any disadvantages associated with the levels of productivity or wages.

3. IMMEDIATE CHANGES

With the freedoms and goals described above, there are a number of changes that the Postal Service would make immediately. First, it would eliminate the “preferred” categories of mail, all of which have rates that are below corresponding commercial rates. This means there would be no separate in-county rates, no separate rates for classroom material, no separate rates for nonprofit organizations (which exist both in Periodicals and in Standard A), no separate rates for Library mail,¹¹ and no separate rates for Science-of-

¹⁰ Other advantages the Postal Service could retain relate to such things as the payment of taxes, the need for a return on investment, the right of eminent domain, and immunity from parking tickets. Congress would have to decide on such issues.

¹¹ Free for the blind mail would continue to be available only if the Government continued to provide a subsidy to support it. Also, the Government might continue special arrangements relating to voter registration. As long as there is an appropriation, these programs do not put the Postal Service at a competitive disadvantage.

agriculture mail. Under the rate levels of the most recently completed rate case, eliminating the preferred categories would yield about one-third of a billion dollars in additional revenue.

Second, several special rate arrangements would be discontinued. Specifically, reduced rates for books would be eliminated, and even if there were a separate subclass for them, it would not have rates that are invariant with distance.¹² Also, Periodicals would not receive reduced rates, and any rates that resulted would not depend on the proportion of advertising content.¹³ These changes would increase revenue by another nine-tenths of a billion dollars. These amounts¹⁴ are not large, but competition generally prevents charging higher rates to some customers in order to fund reduced rates for others.

The above changes would allow substantial reductions in the complexity of rates and in the complexity of the data systems, which in turn would allow improvements in the costs and volumes for the subclasses that remained.

A third change that would be made immediately concerns the provisions for parcel mail in Alaska. Presently, as a matter of policy, senders of parcels to residents in the Alaska Bush (which is not accessible by surface transportation) pay surface rates for mail that is transported by air in low volumes. This would not be done in a

¹² The law currently specifies that the rates for books will not vary with distance. This makes the book subclass very inefficient at serving those for whom it was established.

¹³ Under the existing rate arrangement, the Postal Service can consider externalities in setting rates. This would not occur in a competitive system.

competitive system. To places where surface transportation is not available, senders would be required to pay air rates, and possibly air rates keyed to the characteristics of the Alaskan air system. According to rate case figures, this would provide additional revenues of about \$70 million, but one would expect associated adjustments that went beyond this figure.

Fourth, there would be post office closings. It is not easy to predict which post offices would be closed. Using conservative guidelines, an analysis done in the late 1970s concluded that about 12,000 offices should be closed.¹⁵ Services for people using these offices would be provided in a less expensive way, using contract stations in some cases. Since a number of offices have been closed in the last 20 years, this estimate of 12,000 may not be current. But if \$30,000 per year were saved for 12,000 offices, another one-third of a billion dollars would become available.

Fifth, there might be changes in the role the Postal Service plays in policing the fraudulent use of the mails. In a competitive environment, it might not be left with police powers and the right to select those activities in the crime area that would give it a competitive advantage. One alternative would be to turn this function over to the Department of Justice.

Finally, there are some operational changes that would probably be made. 1) The Postal Service would undoubtedly begin

¹⁴ These amounts were calculated conservatively and would vary by rate case.

handling *unaddressed* mail on city routes,¹⁶ even as it does already on rural routes.¹⁷ 2) The Postal Service might stop (or substantially alter) its detached address label program for advertising mail. For mailers, the use of detached labels would be a poor alternative to using unaddressed mail; for the Postal Service, the use of detached labels is not well aligned with current and future automation plans, and it may aggravate the alignment of rates and costs. 3) The Postal Service would probably make changes in the way postage is sold. Currently it adheres to a policy that postage will be sold at face value, regardless of the costs associated with its sale. A first step might be discounts for the use of meter and permit indicia, which cost much less than stamps, but other changes would follow. (Haldi 1999)

4. BASIC PRODUCTS OFFERED

Except for the creation of worksharing discounts and Express Mail, the basic product line of the Postal Service was inherited from Congress at the time of Postal reorganization in 1970.¹⁸ It is not

¹⁵ At the end of FY 1998, there were 27,952 post offices. Each post office has a postmaster. This count does not include stations, branches, or contract stations. Annual Report of the Postmaster General, 1998.

¹⁶ Unaddressed mail would go to all stops on a carrier's route. Presently, addresses are required on such pieces. This is essentially a make-work scheme: the mailers do the extra work of putting the address on each piece and the Postal Service does the extra work of arranging these pieces in delivery order. Note that the postal services in many other countries carry unaddressed mail.

¹⁷ An alternative to unaddressed mail would be to auction off the right to be a third bundle on specific days in specific post offices. A related change would be to set box rents at what the traffic will bear.

¹⁸ The Express Mail subclass and ECOM were created since 1970. Congress changed the qualifications for In-county rates in 1986. The following subclasses have been eliminated: ECOM, transient, controlled circulation, special delivery, and single-piece third. Limited circulation was eliminated, but it was not a subclass.

known what products would evolve under competition. To stimulate discussion, five perspectives are offered below.

4.1. Speed of Service

Two important characteristics of mail are: 1) it does not cost more to process some batches of mail before others, and 2) the volume of mail fluctuates. To accommodate these fluctuations and use resources evenly, it would seem reasonable to offer two tiers of service: rapid and deferred, with air transportation being used for the rapid product. Other distinctions are possible, such as bulk and non-bulk, but the speed distinction would seem to dominate.

The Postal Service has two basic subclasses for letters and flats: First Class (originally rapid, non-bulk, and sealed against inspection) and Standard A (originally deferrable, bulk, and not sealed against inspection). Over time these distinctions have deteriorated. First, due in part to worksharing programs, there are now bulk categories in First Class. Second, a substantial portion of Standard A is entered into the Postal Service near its destination, in which case the opportunity to defer is limited. Third, mailers and recipients are demanding on-time delivery of Standard A, and the Postal Service is accommodating these interests. One could argue that many mailers are getting First-Class service at Standard-A rates. Fourth, many mailers of First Class are not concerned about inspection. Fifth, the rate structures of First Class and Standard A are dissimilar in rather extreme ways, detracting attention from any focus on service.

Nonetheless, the rationality of service tiers remains. If the MBMFC rule was removed and all mailers could choose between

First Class and Standard A, and if the fundamental distinction between the two was service, one would expect a moderate rate difference based on a real service difference. Also, one would expect increased similarity in their rate structures. But the assumption that change would center around these two subclass may not be a good one. More pervasive changes would seem likely, but it is not clear what they would be.

4.2. Tolerance for the Irregular

Throughout its history, the Postal Service has backed away from constraints on the dimensions and characteristics of pieces that can be mailed. The view has been that its mission is to serve and that whatever is mailed will be delivered. In many cases, and often for the same rate, a piece can be handwritten or typed, awkward or standard in shape, flimsy or stiff.¹⁹ This posture has resulted in the engineers being told to design equipment and mail handling systems that will handle a frightening range of mail characteristics. This has presented design difficulties and has resulted in costly equipment. It has also led to operating difficulties and to high processing costs.

Evidence of tolerance follows: 1) It was not until 1979 that a non-standard surcharge was put on First-Class Mail, and even now it applies only to the first ounce. 2) Except for some recent automation categories, there is no rate distinction in First Class among letters, flats, and parcels. Therefore, a letter weighing more than one ounce

¹⁹ In FY 1998, the Postal Service processed 15 billion handwritten addresses. Annual Report of the Postmaster General, 1998. The report says: "Our clerks or our new technology read your handwriting, no matter how 'creative' it might be." p. 54.

pays the same rate as a flat or a parcel of the same weight. 3) There is no rate distinction in Priority between flats and parcels, even though there could be differences in the equipment used to process them. 4) Except for the barcode discount, Periodicals rates are not based on shape or machinability. Some magazines, for example, are too heavy to be processed on flat sorting machines and newspapers would be expected to have costs different from those of magazines. 5) Handwritten addresses and pieces without Zip Codes are accepted without surcharge. 6) During high-speed, mechanized processing, some flats with open edges become aerodynamic. Yet, despite a large cost difference, there is no rate distinction between these flats and those that can be processed effectively. 7) Nonautomated First-Class and Standard-A mailers have the option of requesting that their mail be processed manually, even though the costs for such processing are substantially higher than mechanized processing.²⁰ It is doubtful that any of these tolerances would exist in a competitive system.

Conceptually, one can visualize a streamlined, low-cost processing system for well-defined letter-size pieces that are machine-readable. Similar systems could exist for flats and for parcels. Such systems might allow lower rates for qualifying mail, while pieces that would not qualify might be rejected or required to pay a surcharge based on costs. Prices that recognize costs send signals to mailers concerning the work that needs to be done. They prevent high-cost mailers from being cross subsidized by low-cost mailers, and they

²⁰ See response to interrogatory OCA/USPS-84 in Docket No. R2000-1.

allow the efficiencies of a low-cost mailstream to be available to all who can use them.

One can surmise that a competitive postal service would do a better job of presenting technologically feasible, low-cost product options to mailers and either rejecting non-conforming pieces or levying surcharges. Certainly a competitor would go after such low-cost pieces first, as has Roadway Package Service in the parcel area.

4.3. Demand

One of the hallmarks of competitive pricing is that higher prices are charged to higher-demand customers. This practice becomes even more pronounced outside of a breakeven requirement, when additions to net revenue can be kept.

Under current conventions the Postal Service sets prices for whole subclasses and cannot select specific customers for surcharges or discounts. And for these subclasses, there are no cases where a lower price will lead to an increase in *net* revenue. However, if there are categories of mail that are attractive to competitors, these categories should be viewed as extremely elastic and the Postal Service would be expected to move its rates toward a lower markup over costs. In other words, competition would force a response from the Postal Service.²¹ Similarly, higher rates would be expected for less elastic categories.

²¹ An extreme, but possibly realistic, situation should not be overlooked. Suppose a potential competitor needed a critical mass in order to begin operations. If one mailer were large enough to provide that mass, or nearly provide it, that mailer, by threatening to leave the Postal Service, might be able to negotiate extremely low rates.

Dealing with this kind of situation is different from anything being done today. Basically, the Postal Service would be expected to assess competition and mailers' willingness to pay, and then to segment its markets as much as possible. Indeed, one would expect a degree of creativity from the Postal Service in finding ways to acknowledge demand.

4.4. Content

The subclasses of mail that exist today are based in considerable degree on content. In short, there is a subclass for library materials, one for books, one for bound printed matter, and several for periodicals. Further, the periodicals subclasses have strict rules on enclosures, have regulations that depend on whether the publication is bound or unbound, and most have rates that depend on whether the material inside is advertising or editorial.²² Also, there are cases where merchandise is treated different from non-merchandise and where, under the MBMFC rule discussed above, some kinds of content may use one subclass and not others.

In cases where the willingness to pay of the sender is related to content, it might be possible to argue that content would continue to be recognized in rates. However, it is quite uncommon for competitive carriers to differentiate based on content. Instead, one would expect the emphasis on content to either decrease significantly or disappear. If content did continue as a rate-setting factor, it would probably take a different form from what now exists.

²² In postal parlance, editorial is defined as material that is not advertising.

4.5. Service Measurement

Under the assumption that the level of service is important, knowledge about the level achieved is important. This has been a difficult issue for the Postal Service. In recent years an external measurement system for First-Class Mail has been developed and one now exists for Priority, but actual service levels for most other subclasses have been a great unknown. To fill this void, many mailers measure the service their own mail receives. The Postal Service usually responds to these measurements by saying that they are not statistically valid or that they are not representative. Nevertheless, it is well known that actual service levels are often quite far from the published standards.

In a Postal Service poised to meet competition, considerably more effort would be directed toward meeting published standards and toward measuring the service achieved. Mailers would demand such performance and such knowledge. Competitors would jump at the chance to meet unmet mailer needs. A step beyond this issue is the question of tracking and tracing. The Postal Service is behind its competitors at this point; under competition, catch-up would be expected to occur at a faster pace.

5. WORKSHARING AND CONTRACTING

One way to compete is to bring the strengths of the private sector in-house. This can be done through worksharing discounts or contracts and is especially effective when mailers can do the work in a different way than the Postal Service. (Mitchell 1999) The amount of work that can be turned over in this way is quite large.

Consider the following example. Suppose mailers can sort addresses on a computer and then print them in ZIP Code order. Suppose further that they can do this for 1.5 cents per piece and that this saves the Postal Service 4 cents per piece. In the areas where worksharing discounts are offered now, the tendency has been to move toward a discount of 4 cents. This lowers the net mailing cost for the mailers involved and makes them less likely to go to competitors. However, if the mailers were not on the verge of stopping the worksharing activity or of going to competitors, the Postal Service would maximize its financial position by giving a discount closer to the figure of 1.5 cents. So, with freedom to compete, there could be important changes in the way worksharing discounts are set. Of course, prior to such changes, information and analysis would be needed.

The Postal Service has extensive worksharing discounts. There are, however, some limitations. First, no discounts are based on any cost savings associated with the avoidance of collection activities. Second, discounts for transportation have been limited to Standard A, Priority over 5 pounds, and parts of Standard B. There are no dropship discounts in Express Mail, none in First Class, limited ones in Periodicals, and none in Special Standard or Library Rate. Furthermore, even the dropship discounts in Standard A are limited. For example, mail traveling 2,000 miles to get to a destination facility gets the same dropship discount as similar mail traveling 200 miles. Similarly, 3 truckloads of mail weighing 3 ounces per piece get the same dropship discount as 1 truckload of mail weighing 1 ounce per

piece. Clearly the Postal Service could do more to transfer some of these operations to the private sector through worksharing discounts.

Another way to shift work to the private sector is through contracts with suppliers. This also has been done. For example, contractors who submit the lowest bids do nearly all of the long-haul trucking. Similarly, air transportation is provided under contract, and a sorting hub for Express Mail is operated under contract. A number of contract stations also exist for retail services. There may, however, be limits to how much contracting can be done effectively, partly because of the time and cost associated with utilizing, placing, and monitoring contracts.

Consider the contract the Postal Service now has with Emery Worldwide to process and transport Priority Mail. The idea was for the low bidder to operate a highly focused sorting and transportation system designed to get Priority Mail delivered on time. Suppose, however, with suitable reverence to Adam Smith, one looks at this plan according to its degree of roundaboutness. Here is what happens: 1) the Postal Service collects the pieces and brings them to a central point. 2) The Postal Service goes through a sorting process to separate those pieces that go to Emery. 3) Emery picks up the pieces at the cutoff time and transports them to its own facility. 4) The pieces are unloaded and fed into sorting machines. 5) After sorting, the pieces are transported to an air facility and then sent by air to a destination, possibly using lower-capacity equipment than the Postal Service might use. 6) The pieces are loaded on a truck and transported to a Postal Service facility. 7) The Postal Service

integrates the pieces back into its own system and takes them to the facility out of which the carriers operate. This sounds like a lot of steps. Taking a degree of writer's license, the alternative is to leave them in the postal system, sort them first, transport them immediately, and deliver them.

The jury is still out on the effectiveness of the Emery contract. There are indications, however, that Emery is losing money, that the Postal Service is spending more than if it had done the work itself, and that there has not been a significant improvement in delivery performance. It appears that the roundaboutness and the associated extra steps may be taking a toll. Whether this is an effective avenue to lower costs and improve performance remains to be seen.

Note that the possibility of contracting out is not limited to operations prior to delivery. If there are economies of scale in delivery, and certainly if mail recipients do not want multiple carriers accessing their mail boxes, it would be possible to define routes, along with their expected workload, and auction them off to the lowest bidder. This is already done on a few "star routes" at about one-half the cost of rural carriers, and it is reportedly being done by competitors of the Postal Services in the parcel area. (O'Reilly)

6. COST RECOGNITION IN RATE DESIGN

Rates for the Postal Service are set following extensive hearings before the Postal Rate Commission. Voluminous testimony is provided, as are the results of numerous cost studies. In fact, the volume of cost data amounts to tens of thousands of pages. Based on the data and the testimony submitted, as well as on evidence

submitted by dozens of intervenors, rates are set in a very detailed way. It is not uncommon for extensive testimony to focus on discount differences of one or two tenths of a cent per piece.

Despite all of this attention, there are weaknesses in what is known about costs. For example: 1) Little is known about the relative costs of flats and parcels in Priority and Express Mail. 2) Not enough is known about the effects of weight on costs in First Class and Standard A, despite extensive related testimony²³. 3) Knowledge is limited on the relation between weight and non-transportation costs in nearly all subclasses. 4) Not enough is known about how non-transportation costs vary with distance. 5) Based on studies that have been questioned extensively, the rates for Standard-A mail do not vary with weight up to about 3.3 ounces. This means, for example, that for a large mailing going 3,000 miles, the same postage would be charged for ¾-ounce pieces requiring one tractor trailer as would be charged for 3-ounce pieces requiring four tractor trailers. 6) The extent of lower costs for higher-volume mailers is unknown.

If the Postal Service faced competition in all areas, some of these weaknesses might be associated with cream that could be skimmed. A response by the Postal Service would be expected. Improved cost studies would result. This is not meant to suggest that costs have not been studied extensively. A great deal of money is being spent on cost studies, but when the budget for these studies is

²³ Competitors understand clearly that 15-ounce pieces of saturation mail can be carried privately for less than Standard-A rates, while 4-ounce pieces cannot.

compared to a revenue that is near \$67 billion, the percentage amount is probably minimal.

When it is suggested that the Postal Service should spend more on cost studies, questions arise about private sector expenditures in this area. There are at least three possibilities. One, other firms spend more. Two, most other productive operations are easier to study and understand, since few firms have 40,000 locations and a large proportion of their workforce working outdoors. Three, operating managers in the private sector, based on their extensive experience, are allowed to prepare mental estimates of what costs probably are. However it would work out, it seems clear that competition would improve the alignment of rates and costs.

7. COSTS BY DESTINATION

In recent years a number of studies have analyzed the widely held belief that rural routes are more expensive than city routes. The findings confirm the expectation to some extent, but the split is not clean. It turns out that the income of the recipients is also important, with many low-income, low-volume city routes being unprofitable. (Cohen 1993) One reason for being concerned about this issue is the possibility that, were the Private Express Statutes to be relaxed, competitors would take the profitable routes and leave the incumbent administration with the unprofitable routes.

In the same vein, mail for the highest-volume recipients is not even delivered — the mailers pick it up. In fact, many of these recipients have unique ZIP Codes and their own sorting bin on the sorting machines. The question then becomes: would a competitive

postal service establish rate tiers based on the destination of the mail? We know, for example, that Roadway Package Service, at least initially, did not solicit mail for residences and that UPS charges extra for addresses designated as residential. Also, UPS selects certain Zip Codes for an additional surcharge. At least for bulk mailers, and in a computerized world, such rate differences are easy to manage.

The Postal Service could, for example, place a Roman numeral in front of each ZIP Code, yielding a code like I-20878-2619. The numeral “I” could indicate a low-cost recipient who picks up mail in bulk. The numeral “II” could indicate locations of average income and stop density that are relatively economical to deliver. The numeral “III” could be for high-cost areas.

Rates based on numerals could result, even though there would be transaction costs. Such a system, however, might not be the most desirable, one downside being that the smallest single-piece mailers could default to a rate that is high enough to cover all destinations. Also, to the extent that mailers send broadly to all destinations, a system of this kind would not change postage bills, it would just increase some rates and decrease others.

Before leaving the question of higher-cost delivery areas, it should be noted that a mitigating option might be to reduce the number of deliveries per week. (Cohen 1999) Although many observers would view this as an extreme step it could reduce costs and allow increased efficiencies. For example, mail could be sorted one day and delivered the next, resulting in a less demanding schedule. Also, the effect on the recipient might not be as large as

commonly assumed—in effect, one-half of the mail would be delayed one day.

A related service issue is whether there are unreasonable transportation runs that should be eliminated. That is, a review could be done to see how many transportation runs are scheduled solely to meet a deadline or a service standard, but which involve very little mail. These runs could cost far more than the value of the small improvement in service.

8. COSTS BY CUSTOMER

Although the details are kept private, it is well known that many private-sector firms set rates via contracts with selected customers. Sometimes these are based on agreements that the customer will prepare the mail in certain ways; at other times they are based on a threat that the mailer will find another carrier. As an economic matter, it is clear that a postal service is better off having a customer at a near-cost price than not having the customer at all.

Were the Postal Service to be allowed to set rates under contracts, or to bid for business, it would need costs by customer. At the present time, costs by customer are not available and the Service's costing systems are not set up to develop such costs. In short, this is a whole new costing area that would need to be undertaken.²⁴

If contract rates with selected customers were allowed, several questions would need to be addressed. First, would the terms of each agreement be made public? The answer is probably yes. Second,

would all customers satisfying the requirements of the contract be allowed to use the same rates? The answer here is probably yes as well, even though private-sector firms would say no on both points. Third, how rigorous and defensible would customer-specific costs have to be in order to qualify as an acceptable base for a contract, and would the costing receive review by any outside party? One is tempted to argue that there should be a defensible study, but the problem is obvious— some private firms undoubtedly base contracts on the judgment of the managers involved. Furthermore, the result can be based on negotiating skills.

The prospect of allowing contract prices in a government postal service, based on judgment and negotiating skills, raises another question. Specifically, private firms have stockholders. If discounts are too large, the stockholders pay, along with managers who may lose their jobs. Whether a government postal service can engage in these kinds of negotiations deserves serious study.

9. INVERSE PRICE CAPS

If the Postal Service should have a greater degree of pricing freedom and be able to engage in negotiations with selected mailers, one way to provide such freedom, even without further changes, would be to allow the Postal Service to operate under inverse price caps.

Within the existing rate-setting framework, the idea of an inverse price cap is to allow the Commission to recommend an

²⁴ Part of the recent appeal of Activity Based Costing systems is that they help

average price level (or index) that is viewed as a floor. Then the Postal Service could make wide-ranging adjustments of the rates in the subclass, including contract rates for some of the subclass users, as long as the average rate for the subclass does not go below the inverse cap. If the Commission believed that a low markup for the subclasses was in order, then the low markup could be recommended. Full review would be provided and all affected parties would have an opportunity to be heard. This is an alternative to some recent legislative suggestions that the markup on the competitive subclasses as a group must be at least as large as the markup on all other subclasses.

The inverse price cap is a relatively simple notion that would require no more than a minor adjustment to the law, if one is needed at all. It deserves further study. Within the framework of this paper, it could play a role as well. Specifically, suppose unconstrained competition were allowed but the Postal Service turned out to have sufficient market power in some product areas to allow other products to be priced at or near the level of incremental cost. If this was viewed as unfair competition, an independent regulatory commission could establish and monitor certain inverse price caps. This would provide substantial freedom to compete, but within a constrained framework.

10. HAVING A GOVERNMENT PROVIDER

One of the questions of this paper is whether the Postal Service could become a sustainable monopoly if all protection were removed. There are both disadvantages and advantages to having a single government provider under these conditions. Among the disadvantages are that the degree of innovation and product differentiation might continue to be limited. On the advantages side, several considerations are relevant. The Postal Service has established the zones and the ZIP Codes that are now used by all carriers. It also manages a forwarding system and a change-of-address system,²⁵ both of which honor policies on privacy. In addition, it carries mail that is sealed against inspection and acts as a watchdog over fraudulent use of the mails.

If desired, having one carrier would allow the maintenance of the mailbox rule (with, as discussed above, a reduction in competitive pressure), which in turn would be helpful in protecting the mail. Also, residents could leave originating mail in their boxes and know who would pick it up and that it would be handled appropriately. Having one carrier would also reduce vehicle traffic in neighborhoods and allow familiarity with recipients. Such a carrier can deal better with irregularities and can watch over the delivery area.

²⁵ If competition was allowed and competitors arose, it might be that a change-of-address system could be operated by a separate entity and made available to all competitors. This is reportedly being done in Sweden.

11. CONCLUSION

It is a common belief that the Private Express Statutes and the mailbox rule serve as protection to allow universal service at uniform rates. When viewed in terms of changes the Postal Service would likely make if it wished to make itself into a sustainable monopoly, it becomes clear that these restrictions protect much more than just universal service. They also protect the preferred subclasses of mail, low rates for Periodicals, classifications that are not market based, rates that do not follow costs, and a range of other practices discussed in this paper. If these are not inherently desirable, or if a decision were made to give them less weight, changes could be made to eliminate them now, even without relaxing the Statutes. If some of them are desirable but not others, limited changes could be made, one possibility being inverse price caps.

There are, however, benefits to having a government postal service, in addition to the uniform rates and special rate structures. Specifically, the Postal Service establishes the zones and the ZIP Codes, guards privacy, forwards mail, and protects against crime. Also, having one postal system reduces traffic and pollution. Further, if the mailbox rule were maintained, only one person will pick up an outgoing letter placed in the mailbox.

Further analysis is needed of the benefits of the current system relative to the benefits of an alternative system, and of whether some of the benefits of an alternative system can be obtained by making adjustments to the current system.

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