

# IRET Congressional Advisory

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## **IS THE POSTAL RATE-SETTING PROCESS BROKEN?**

### *Executive Summary*

The Postal Service has long maintained that it needs more pricing flexibility than is currently provided by the rate-setting process, and has urged Congress to allow looser rate regulation. Is the claim true, and is the remedy necessary or wise? Consider some recent developments.

As the Postal Service prepares to file its next rate case, probably in early 2005, it is considering asking its independent rate regulator, the Postal Rate Commission (PRC), to approve a phased-in rate increase. The Service thinks a phase-in would smooth its income stream and be less of a shock to its customers' budgets. The Service has never before requested a multi-step rate change.

Negotiated service agreements (NSAs) are another pricing innovation for the Postal Service. The PRC approved the first in 2003, the second in 2004, and a third is pending. If properly constructed, NSAs can save money for the Postal Service and the customers with which it signs NSAs, while being fair to third parties.

Phased-in rate changes and NSAs are often mentioned in discussions of how to add flexibility to the Postal Service's product pricing. Both seem to be permitted under current law. The main stumbling block in the past was the Postal Service itself. It is only now considering phased-in rate changes, and the current Postmaster General, John Potter, was the first to request an NSA.

Current law offers additional opportunities for streamlining the rate-setting process, if the Postal Service is willing to work with its rate regulator.

The availability of NSAs, phased-in rate changes, and additional pricing options undercuts the Service's claim that present-law rate regulation is so awkward and rigid that Congress needs to scrap the current system and replace it with looser rate regulation.

The Postal Service is a government-owned entity; it possesses statutory monopolies on non-urgent letter delivery and access to mailboxes; and it enjoys a variety of other government-based privileges. Given the agency's powers and the incentives it faces, careful rate regulation is a prudent and desirable safeguard.

Legislative reforms would do far more good in other areas, such as helping the Postal Service manage its costs better or focusing the agency on its core governmental mission by limiting its involvement in competitive markets.

## IS THE POSTAL RATE-SETTING PROCESS BROKEN?

The Postal Service has long maintained that it needs more pricing flexibility than is currently provided by the rate-setting process, and has urged Congress to allow looser rate regulation. Is the claim true, and is the remedy necessary or wise? Consider some recent developments.

The Postal Service is reportedly considering whether to seek a rate increase that would be phased in over two years.<sup>1</sup> According to the idea being floated, the Service would ask the Postal Rate Commission (PRC), the independent federal agency that oversees its rates, to approve a two-step rate hike, with increases in 2006 and 2007, instead of requesting a single larger rate hike in 2006. (The rate on single-piece first-class mail, which is the type of mail usually sent by households, would still increase in one step. The thinking may be that people who do not mail many letters would prefer not to bother with frequent rate changes.)

Stephen Kearney, the Service's vice president of pricing and classification, is quoted in *DM News* as saying, "We are thinking about [this plan] for the next rate case, but nothing is definite... However, in the best of both worlds, we plan to file a rate case where the rates would be phased in two phases, and, ultimately, we'd like that to become our long-term pattern because we think customers will value the predictability and smaller increases."<sup>2</sup>

The Postal Service last increased its rates effective June 30, 2002. Aided by legislation that reduced the agency's expenses by permitting a recomputation of its pension obligations<sup>3</sup>, the Service has held rates steady since then and promised to continue doing so through 2005. Soon, though, the Service will file a rate case with the PRC, and it is expected to request a substantial increase.

The Service has never before increased rates in steps. The usual pattern in the past has been a large increase once every few years, with the Service's financial results improving immediately following

the increase and then deteriorating as costs outpaced revenues until the next rate increase several years later.

Another pricing innovation at the Postal Service is negotiated service agreements (NSAs). The Postal Service entered into its first NSA in 2003, with Capital One. Now a second NSA has been approved, this time with Discover Financial Services. Mr. Kearney explained in a Postal Service news release that NSAs involve "tailoring prices and products" to meet the needs of a mailer and the Postal Service. "These contractual agreements allow us to ... work individually with customers to develop pricing and service incentives that benefit both parties and, ultimately, all customers."<sup>4</sup>

Before implementing an NSA, the Service must seek approval from its rate regulator. The PRC then initiates a proceeding to evaluate whether the NSA is in the best interest of the Postal Service and is fair to other mail customers. The Service submitted the NSA with Discover to the PRC in June. Moving quickly, the PRC initiated a proceeding and approved the NSA in September.<sup>5</sup> Both of the NSAs authorized so far involve volume discounts and allow the Service to save money by providing electronic address corrections instead of physically returning undeliverable first-class mail. A third NSA, with Bank One, is pending.

Phased-in rate increases and NSAs hold the promise of being economically beneficial to all parties, provided they are properly constructed. They are also worth examining because they shed light on the complaint made by the Postal Service that the agency is in a regulatory straightjacket regarding the prices it charges and that it needs a legislative fix from Congress.

**Potential gains.** Phasing in a rate hike makes sense for the Postal Service. The Service has often stated that large, irregular rate increases produce sharp income swings that complicate its cash management and make the organization look more financially

unstable than would be the case if rate hikes were smaller and more frequent. The Service also claims that most mailers could more easily adjust their budgets in response to smaller, more regular rate increases than to larger, less frequent ones. If these claims are true, a multi-stage rate increase would be a win-win, with modest benefits for both the Postal Service and its customers.<sup>6</sup>

If properly structured, negotiated service agreements may also be beneficial. One key question is whether a proposed NSA would help the Postal Service financially. To do that it must provide sufficient cost savings or a large enough revenue increase that it improves the Service's bottom line. Another vital question is whether a proposed NSA, which involves an agreement between the Postal Service and a particular mailer, would be fair to other parties. This second issue arises because the Postal Service, as part of the federal government, is not supposed to show favoritism to some customers over others. If the answer to both these questions is "yes", a proposed NSA would be a win-win; otherwise, it should probably be rejected.

#### **Current-law rate regulation and its importance.**

The Postal Service is an enterprise wholly owned by the federal government. It possesses dual statutory monopolies on the delivery of non-urgent letters and on access to people's mailboxes. Further, it enjoys an array of government-based privileges, such as exemptions from many of the taxes and government fees that private-sector businesses must pay. Because of these conditions, careful regulatory oversight is prudent.

One natural concern is that an unregulated or weakly regulated Postal Service might abuse its monopoly power by charging monopoly-level prices to customers within its sheltered core market. As explained in several earlier papers in this series, another concern is that the agency's governmental status may give it incentives to overexpand in competitive markets, inducing it to charge prices in competitive markets that are too low relative to costs and that are supported by subsidies from taxpayers and from customers within the postal monopoly.<sup>7</sup>

The aim of regulation is to offer some protection against these potential abuses.<sup>8</sup>

Under current law, the Postal Service in most cases must seek approval from an independent federal regulatory agency, the Postal Rate Commission (PRC), before it can change the prices of its products.<sup>9</sup> After the PRC receives a rate request, it schedules a formal rate hearing at which it gathers testimony from the Postal Service and allows other interested parties to provide evidence and seek information. Within 10 months of receiving a rate request, the PRC must generally issue a recommended decision. The decision is based on the evidence presented during the rate hearing and a number of considerations specified by statute.<sup>10</sup>

Prior regulatory review is also required under current law in order to implement a staggered rate increase (assuming the Service requests one) or negotiated service agreement. In these cases, as well, it is a valuable safeguard. Before the Postal Service imposes a phased-in rate hike, the PRC should determine whether rates at each stage would be reasonable relative to the Service's costs. If customers have suggestions or reservations, their views should be known, and the rate hearing will allow them a timely forum in which to present evidence. Before the Service enters into an NSA, the PRC should examine whether the arrangement is likely to assist the Service financially and be fair to third parties. The evidence provided by the Service, the mailer seeking the NSA, and third parties who support or oppose the NSA will help the PRC to uncover the facts.

To be sure, government regulatory activities are generally time consuming and expensive, and current-law rate regulation of the Postal Service is no exception. Rate cases take months to be prepared, heard, and decided, and the associated paperwork costs are substantial. Again, however, vigilant oversight is justified because of the harm that might occur if rate regulation were lax.

In contrast to private-sector companies in regulated industries, Congress has given the Postal

Service an escape hatch if the agency strongly believes a regulatory decision is incorrect. By a unanimous, written vote of its governors, the Postal Service can overrule its rate regulator and impose a rate change the PRC has rejected.<sup>11</sup>

**The Postal Service seeks less rate regulation.** Ever since it was created from the old Post Office Department by the Postal Reorganization Act of 1970, the Postal Service has complained that it is subject to excessive and unnecessary rate regulation. The agency's view is that Congress needs to change the law so that the agency has more power to set and adjust its prices on its own.

For example, the Postal Service characterized the substitution of "flexible pricing" for current rate regulation as both a "moderate legislative reform" and a "key" reform in the *Transformation Plan* it issued in April 2002.<sup>12</sup> In 2003, in testimony to the bipartisan President's Commission on the U.S. Postal Service, Postmaster General John Potter brought up the agency's "priorities in the near term when it comes to changes in the law" and said, "Pricing flexibility is at the top of the list."<sup>13</sup> David Fineman, Chairman of the Postal Service's Board of Governors, delivered a similar message in January 2004. He told Congress, "The rate process is broken,"<sup>14</sup> adding that he had often given Congress the same warning in the past.

**Phased-in rate changes and NSAs indicate current law does provide pricing flexibility.** In evaluating the Postal Service's call for looser rate regulation, one of the main issues is whether current law is as restrictive as the Postal Service insists. If the current rate setting process is truly dysfunctional, the case for fundamentally revamping it would be much stronger than otherwise.

Multi-stage rate changes and NSAs are highly relevant in this discussion. They are often mentioned as ways significantly to increase pricing flexibility. But they do not require new law; *they are already permissible under current law.* In the *Transformation Plan* it issued in 2002, the Postal Service said, "Within the framework of the current rate-making process, the Postal Service will request

several reforms to respond to customer pricing needs and restore postal finances to a more sound footing."<sup>15</sup> Two of the innovations it mentioned were phased-in rate increases and NSAs.

Because the Postal Service had never previously requested either, it added the caveat, "The Postal Service believes that some of these reforms can be implemented administratively with the assistance of the PRC. In the event that efforts to achieve these changes identify hurdles that cannot be cleared within the scope of our existing statute, we will ask Congress to enact legislation to remove those hurdles."<sup>16</sup> As subsequent events have demonstrated, though, NSAs are possible under current law. The main hurdle to a phased-in rate change appears to be that the Postal Service has not yet requested one.

It is also revealing that although NSAs have been discussed "since at least the 1970s,"<sup>17</sup> the Postal Service did not ask for one until a two years ago and has never before sought a multi-step rate increase. The impression is that while the agency finds it convenient to describe price flexibility as essential when trying to persuade Congress to modify the law, it has been very slow to exercise the price flexibility that current law already gives it. The Postal Service's claim that the rate setting process is horribly restrictive and must be totally overhauled would be more convincing if the agency had long ago begun employing the pricing flexibility that current law already grants it.

Current law offers other opportunities for accelerating the rate setting process while maintaining responsible regulatory oversight. PRC Commissioner Ruth Goldway has noted several and urged the Postal Service to make greater use of them. For example, while "omnibus rate cases are time consuming, [which is] a price we pay for due process ... [the Service] can file niche classification cases, or cases involving narrowly focused rate changes, that may take little time."<sup>18</sup> For major rate cases, Commissioner Goldway suggested a reform permitted by current law that would greatly simplify the ratemaking process. In rate cases, the parties would use pre-agreed-upon cost-measurement

rules and not seek to change mail classifications, which means "separating rate cases from methodology and classification cases." She added, "Such a reform might make ratemaking into a fairly quick exercise of plugging updated cost data into a formula."<sup>19</sup>

**Conclusion.** It is a credit to Postmaster General Potter and his management team that since he became Postmaster General in 2001, the Postal Service has begun using more of the pricing flexibility available to it under current law. Two negotiated service agreements have been approved with a third pending, and the Service may request a multi-stage rate increase in the next rate case. These are sensible pricing innovations that can potentially assist all parties. Before-the-fact hearings by the PRC provide needed regulatory oversight.

The availability under current law of negotiated service agreements, phased-in rate changes, and other pricing innovations the Postal Service has not yet explored does not mean the current rate-setting process is perfect. It does indicate, though, that the process is more flexible than one would conclude based on the Postal Service's complaints. That pricing flexibility weakens the case for scrapping the current rate-setting system — allegedly because it is too rigid — and replacing it with a rate-setting mechanism featuring less regulatory oversight of prices and more leeway for the Postal Service.

Nevertheless, influenced by Postal Service complaints that the rate setting process is broken, House and Senate committees earlier this year

reported out legislation whose central element is a new mechanism for changing Postal Service prices (the Postal Accountability and Enhancement Act, H. R. 4341 and S. 2468). As long as rates stay within certain limits, the legislation would let the Service alter rates on its own initiative with only loose regulatory oversight. The legislation did not advance to a floor vote in either chamber.

If current rate regulation actually did hobble the Postal Service's performance, legislative reform of the rate-setting process would be imperative. The failure of relaxed rate regulation to win Congressional approval this year would then be grounds for deep concern. Fortunately, current law already gives the Postal Service much of the price flexibility it says it lacks, provided the agency is willing to work with its rate regulator.

This is not to say that legislative reforms are unneeded. Reforms should be made, but in areas where the problems are more real and pressing. An excellent centerpiece for legislation would be cost-control reforms. Legal constraints now make it much harder for the Postal Service to manage its costs than it should be. Given that the Service is part of the federal government, another highly desirable reform would be focusing the agency on its core governmental mission by limiting its operations in competitive markets already served by private-sector businesses.

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## *Endnotes*

1. See Melissa Campanelli, "USPS May File Phased Rate Increase in '05," *DM News*, November 5, 2004, accessed on the Internet at [http://www.dmnews.com/cgi-bin/artprevbot.cgi?article\\_id=30946](http://www.dmnews.com/cgi-bin/artprevbot.cgi?article_id=30946).
2. *Ibid.*
3. Postal Civil Service Retirement System Funding Reform Act of 2003 (P.L. 108-18).
4. U.S. Postal Service, "Postal Service, Discover Agreement Approved," News Release No. 04-070, October 28, 2004, accessed on the Internet at [http://www.usps.com/communications/news/press/2004/pr04\\_070.pdf](http://www.usps.com/communications/news/press/2004/pr04_070.pdf).
5. See Postal Rate Commission, "Opinion And Recommended Decision Approving Negotiated Service Agreement," Docket No. MC2004-4, September 30, 2004, accessed on the Internet at <http://www.prc.gov/docs/41/41896/Opinion.pdf>.
6. There might also be a small economic efficiency gain because more frequent and gradual rate changes would allow rates to stay better aligned with costs. When rates are boosted in large steps every few years, rates just after the increase may be "too high" relative to costs, excessively curtailing mail demand, while rates at the end of the cycle may be "too low" relative to costs, leading to too much mail use.
7. See, for example, Michael Schuyler, "Postal Service's Immunity From Antitrust Laws Should Be Restricted," *IRET Congressional Advisory*, No. 172, April 21, 2004, available on the Internet at <ftp://ftp.iret.org/pub/ADVS-172.PDF>; Michael Schuyler, "The Danger Of Monopoly-Subsidized Pricing By The Postal Service In Competitive Markets," *IRET Congressional Advisory*, No. 170, April 1, 2004, available on the Internet at <ftp://ftp.iret.org/pub/ADVS-170.PDF>; and Michael Schuyler, "Empire Building At The Postal Service," *IRET Policy Bulletin*, No. 87, May 19, 2003, available on the Internet at <ftp://ftp.iret.org/pub/BLTN-87.PDF>. Many government subsidies are indirect and hidden. For rough estimates of some of the hidden subsidies at three federal government enterprises — the Postal Service, Amtrak, and the Tennessee Valley Authority, see Michael Schuyler, *The Anti-Competitive Edge: Government Subsidies To Government Businesses: Case Studies Of The Postal Service, TVA, And Amtrak* (Washington, DC: Institute For Research On The Economics Of Taxation, 1999). For evidence that the Postal Service's prices are high relative to costs within its monopoly but low relative to costs in competitive markets, see Michael Schuyler, "Uneven Price Markups Distort Postal Service Mission," *IRET Congressional Advisory*, No. 165, December 11, 2003, available on the Internet at <ftp://ftp.iret.org/pub/ADVS-170.PDF>.
8. Rate regulation would not be warranted if the Postal Service were an ordinary business. It would be an ordinary business if, contrary to fact, it were a private-sector company instead of a government enterprise, did not possess dual statutory monopolies, and did not enjoy numerous other government-based powers and privileges.
9. See Postal Reorganization Act Of 1970 (P.L. 91-375), sec. 3621-3622, codified in 39 USC, sec. 3621-3622. One exception is that the Postal Service can set international mail rates without having to ask the PRC for approval. Also, the Service and the PRC disagree about whether the PRC has regulatory oversight over the prices of some non-mail products sold by the agency, such as prepaid telephone calling cards, retail merchandise sold in post office lobbies, and greeting cards sold from the Postal Service's Website.
10. See Postal Reorganization Act Of 1970 (P.L. 91-375), sec. 3623-3624, codified in 39 USC, sec. 3623-3624. Congress added the 10 month time limit in 1976 (Postal Reorganization Act Amendments of 1976, P.L. 94-421, codified as 39 USC, sec. 3624(c)(1)) in order for rate cases to be decided in a more timely fashion. (The law allows the PRC to extend the time limit, though, if the Postal Service delays unreasonably in responding to lawful PRC requests for information.)
11. Postal Reorganization Act Of 1970 (P.L. 91-375), sec. 3625, codified in 39 USC, sec. 3625. Although the Postal Service has exercised this power only a few times, that has been sufficient to keep the PRC aware of its existence and may bring PRC recommended decisions somewhat closer to what the Postal Service wants than otherwise.
12. United States Postal Service, *United States Postal Service Transformation Plan*, April 2002, p. B-3, accessed on the Internet at <http://www.usps.com/strategicdirection/transform.htm>.

13. John E. Potter, "Remarks by Postmaster General John E. Potter," testimony to President's Commission on the U.S. Postal Service, May 29, 2003, accessed on the Internet at [http://www.usps.com/communications/news/speeches/2003/sp03\\_pmg0529.pdf](http://www.usps.com/communications/news/speeches/2003/sp03_pmg0529.pdf).
14. David Fineman, Chairman, U.S. Postal Service Board Of Governors, "Statement Of David Fineman," January 28, 2004 in *Answering The Administration's Call For Postal Reform—Parts I, II, and III*, Hearings Before The Special Panel On Postal Reform And Oversight Of The Committee On Government Reform, House of Representatives, One Hundred Eighth Congress, Second Session, January 28, February 5 and 11, 2004, Serial No. 108–135, p. 29, accessed on the Internet at <http://www.access.gpo.gov/congress/house/pdf/108hr/93087.pdf>.
15. U.S. Postal Service, *Transformation Plan*, *op. cit.*, p. vi.
16. *Ibid.*, pp. vi-vii.
17. *Ibid.*, p. 50. In its decision approving the NSA with Capital One, the PRC noted, "The legality and efficacy of NSAs involving the Postal Service have been controversial issues for more than a decade." (Postal Rate Commission, "Experimental Rate And Service Changes To Implement Negotiated Service Agreement With Capital One," Opinion And Recommended Decision, Docket No. MC2002-2, May 15, 2003, p. 1, accessed on the Internet at <http://www.prc.gov/docs/38/38142/MC2002-2.pdf>.) Perhaps the uncertainty deterred the Postal Service from requesting an NSA sooner, but, as events proved, asking for an NSA was the most direct way to resolve the uncertainty.
18. Ruth Y. Goldway, "Comments To The President's Commission On The United States Postal Service," Submitted by Ruth Y. Goldway, Commissioner Postal Rate Commission, February 3, 2003, accessed on the Internet at [http://www.postcom.org/public/2003/goldway\\_statement.htm](http://www.postcom.org/public/2003/goldway_statement.htm).
19. *Ibid.*