IRET *Congressional Advisory*

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

June 20, 2005 **Advisory No. 188**

RATE-CAP REGULATION WILL NOT DELIVER REAL POSTAL SERVICE REFORM

Executive Summary

At present, the Postal Service must seek prior approval from an independent federal regulator, the Postal Rate Commission (PRC), before changing the prices of its products.

Two bills before Congress, H.R. 22 and S. 662, would loosen rate regulation. In markets the Postal Service dominates, the bills would give the agency much more rate-setting discretion, provided it does not raise prices faster than inflation. In competitive markets, the Service could set virtually any prices it wants, provided rates at least cover products' costs, as measured by the Service.

The bills' fundamental assumption is that rate-cap regulation would motivate the agency to operate more efficiently.

Rate-cap regulation, however, is poorly designed for a government-owned enterprise like the Postal Service. Government enterprises lack the market discipline provided by private owner/investors (residual claimants), who are eager to improve efficiency in order to increase profits.

The Service's main financial problem is high and rising costs. The bills would do little to help the Service better manage its costs — except for shifting billions of dollars of pension costs from the Postal Service to the Treasury, which would not lower the government's overall costs whatsoever.

The Service indirectly acknowledges that costs are its biggest problem when it warns that rising costs may not permit it to stay within a rate cap and demands a legislative escape clause.

Looser rate regulation would increase the danger that the Postal Service will impose excessive rate hikes on products within its monopoly power. On numerous occasions, the PRC has had to scale back excessive rate-hike requests, especially on first-class mail.

Relaxed rate regulation is also a threat to transparency and accountability.

If price flexibility were the secret to financial health, most airlines would be booming, as would Amtrak. In reality, price flexibility does little good when costs are high.

H.R. 22 and S. 662 approach Postal Service reform from the wrong direction. Careful rate regulation is desirable at a giant government-owned enterprise that possesses a huge core market sheltered by a statutory monopoly.

RATE-CAP REGULATION WILL NOT DELIVER REAL POSTAL SERVICE REFORM

In 2004, the House Government Reform Committee unanimously reported out the "Postal Accountability and Enhancement Act" (H. R. 4341) and the Senate Governmental Affairs Committee, also unanimously, approved a bill with the same title but some differences in language (S. 2468). The bills stalled due to concerns regarding some of their provisions, election year time pressures, and disputes within Congress. At the start of 2005, Rep. John McHugh (R-NY), who has long been at the forefront of Congressional efforts to pass Postal Service legislation, introduced H.R. 22, which is a slight modification of last year's H.R. 4341. The House Government Reform Committee unanimously approved it on April 13, with several amendments. On the Senate side, in March, Senators Susan Collins (R-ME) and Thomas Carper (D-DE), who have also been active in this area in recent years, introduced S. 662, which is an updated version of S. 2468.

If either of these bills, or some combination, were to be enacted, it would be the biggest overhaul of the laws governing the U.S. Postal Service since the Postal Reorganization Act of 1970, which created the current government mail-delivery agency from the old Post Office Department. The central feature of the bills is a new system for regulating the prices that the Postal Service charges for its products.

Responding to the opposing complaints of the Postal Service that it should be able to increase rates with less oversight by its rate regulator and of mailers that rate increases should be smaller, the bills would discard the current rate-setting process. The bills' authors hope that a new regulatory system, which the bills call "modern rate regulation"[1], would simultaneously strengthen the Service's bottom line and improve its quality of service. The proposed rate-setting process would supposedly allow the government-owned Postal Service to respond more quickly to market opportunities and motivate it to become more efficient.

In 2003, the bipartisan President's Commission on the U.S. Postal Service had also recommended changes in rate regulation, but as part of a package whose central element would be better control of the Service's high costs. The Commission also recognized the importance of greater transparency at the Service and a tighter focus on its governmental mission.[2]

In contrast, H.R. 22 and S. 662 (and their predecessors) are weak in terms of cost-control tools, unless one counts proposed statutory changes that would not lower total government costs by even a cent but would shift billions of dollars of costs from the Postal Service to the U.S. Treasury.

Would the rate-setting regime at the heart of H.R. 22 and S. 662 generate the benefits that are promised? If the answer is affirmative, that system of rate regulation would be a solid foundation on which to build Postal Service reform. On the other hand, if the benefits of overhauling the rate-setting process have been oversold or if the proposed new system entails significant dangers, a bill that revamps the rate setting process but is weak in other areas would fail to provide meaningful reform and might actually be harmful.

The bills are complicated and raise many issues. This paper is not intended to provide an overall assessment of the two legislative proposals. The spotlight here is on rate regulation. While that is the bills' centerpiece, H.R. 22 and S. 662 also cover many other areas.[3]

How the Postal Service's prices are adjusted. Prior to the Postal Reorganization Act, Congress itself set rates for the old Post Office Department. That arrangement functioned poorly because Congress found it politically difficult to raise rates and usually kept them too low, which contributed to the Post Office Department's huge deficits. When Congress reorganized the Post Office Department into the U.S. Postal Service, it kept the Postal Service within the government and created a second, independent federal agency, the Postal Rate Commission (PRC), to regulate the prices that the Service charges.[4]

In most cases under current law, the Postal Service must seek the PRC's approval before it can change the prices of its products.[5] On receiving a rate request, the PRC initiates a rate case and holds formal hearings. The PRC must issue a recommended decision within 10 months.[6] The PRC bases its decision on the evidence and nine factors specified by statute. One of the factors is the requirement that rates be set so that each product category is expected to cover at least its own costs.[7] Further, the PRC must recommend rates that, in the aggregate, will allow the Postal Service to cover its costs.[8] This type of rate regulation, in which rates are ultimately tied to costs, is known as cost-of-service regulation. A limitation on the PRC's regulatory authority is that the Postal Service can impose a rate change the PRC has rejected, if the Service's governors vote unanimously to do so.[9]

Although the rate-setting process is time consuming, the Postal Service does have opportunities under current laws and regulations to speed up rate cases and increase pricing flexibility, but it has been slow to take advantage of those opportunities. For example, negotiated service agreements (NSAs) and phased-in rate increases are often mentioned in discussions of flexible pricing. Both appear to be allowed under current law and do not require new legislation. Yet, the Postal Service did not submit its first NSA request to the PRC until 2002 (it was approved several months later and more have followed), and the agency has never filed a rate case asking for a phased-in rate increase.[10] Further, the Service is actively resisting a PRC initiative that would allow rate cases to proceed more expeditiously by having the Service regularly disclose more about its finances, which would clarify in advance many of the costing issues that now slow down rate cases.[11]

Rate regulation under H.R. 22 and S. 662. The proposed legislation would divide the agency's products into two categories for purposes of rate regulation: market-dominant products and competitive products. Very roughly, these categories correspond to products over which the Postal Service has considerable market power (the market-dominant category) and those over which it does not (the competitive category). Because the Service's primary source of market power is its dual statutory monopolies, the main items in the market-dominant category are the agency's core products of non-urgent letter delivery and periodical delivery.[12]

In both categories, the bills would let the Postal Service alter prices largely at its own discretion, provided it stayed within certain limits.

For products on the market-dominant list, the restriction is that the Service could not normally increase prices faster than the inflation rate, as measured by the Consumer Price Index (CPI).[13] In effect, this would replace the current cost-of-service rate regulation with what is known as rate-cap or price-cap regulation.

The bills also contain an exception: a clause permitting larger rate increases. H.R. 22 would allow the PRC to approve a rate increase exceeding the consumer price index if it determines, after holding hearings and receiving comments, that the increase is "reasonable and equitable and necessary"; and S. 662 would require the regulator to "establish procedures whereby rates may be adjusted on an expedited basis due to unexpected and extraordinary circumstances."[14]

In the competitive category, the bills would let the Postal Service charge virtually whatever prices it wanted as long as two cost conditions are met: each competitive product must cover its own costs (as the Postal Service measures those costs) and competitive products, collectively, must make a contribution to overhead costs that the agency's regulator thinks is appropriate.[15] The Service's pricing decisions could be challenged, but the regulator would only have a few weeks to review proposed changes before they took effect. The bills' statutory language suggests the Service's pricing of its competitive-market products would normally pass regulatory muster if the above limitations are met.

Calls for change. The Postal Service has long complained that the current regulatory framework is too burdensome and rigid. The agency insists current rate regulation is a barrier to financial success and should be replaced by looser oversight. In its 2002 "Transformation Plan", the Service recommended that it be given "broad flexibility to set prices within overall parameters managed by the PRC and the Board of Governors..."[16] The Postal Service added that it should be able to change prices without having first to seek regulatory approval[17], and should essentially not be subject to rate regulation at all on its non-monopoly products."[18]

In 2003, Postmaster General John Potter emphasized the agency's unhappiness with current rate regulation by saying that "pricing flexibility is at the top of the list" among the agency's near-term legislative priorities.[19] In 2004, David Fineman, who was then Chairman of the Service's Board of Governors, told Congress that in his opinion, "The rate process is broken."[20] Mr. Fineman also told Congress, "[W]e would support a system including a well-constructed price cap model that properly addresses the Postal Service's economic situation."[21]

Others have also spoken approvingly of price-cap rate setting. Because postage is one of the biggest expenses of large commercial mailers, many of them favor price-cap regulation in the hope it would hold down future rate increases. They seek a rigid price cap, and oppose allowing an exception for faster rate increases in some circumstances. For instance, Ann Moore, the head of Time, told Congress:

> It is crucial that Congress put a rational rate cap system in place to prevent unsustainable rate increases... We suggest that rate increases not exceed some inflation-based benchmark... [Further] we would suggest the elimination of the exigent circumstances exception...[to] provide a strong incentive for the Postal Service to operate below the rate cap.[22]

As mentioned earlier, the bipartisan President's Commission on the U.S. Postal Service emphasized better cost management and improved efficiency as the keys to a viable Postal Service. It is important to note that within this context the Commission supported rate-cap regulation as an additional means of "imposing firm price and spending discipline."[23] Specifically, the Commission recommended that the PRC limit price increases for the Service's monopoly-sheltered products to the inflation rate minus an adjustment for anticipated technological improvements, meaning that prices would rise by less than the inflation rate. The Commission also recommended that the Postal Service focus on its core governmental mission instead of trying to expand in competitive markets. For those competitive-market products that remained, the Commission suggested letting the Service set its own prices, subject to a strict prohibition against cross-subsidization and greatly enhanced transparency and cost allocation to better identify subsidies. The Commission would effectively create the necessary price floor to insure that all costs are recovered by products.

H.R. 22 and S. 662 appear inconsistent with the Commission's recommendations because they lack most of the cost-containment and pro-efficiency legislative reforms that the Commission recommended. The bills also lack a technology adjustment, which means they would permit larger rate increases and provide less financial discipline than the bipartisan President's Commission recommended. A report prepared for the Commission warned that price-cap regulation would be foolhardy without much better cost controls.[24]

The need for regulation. The Postal Service has never been enthusiastic about rate regulation, and has sometimes seemed to question whether regulation is needed at all. The Service is correct that regulation is expensive in terms of time and dollars. Despite the costs, however, careful regulation is justified because doing without it would put the public at risk.

The obvious reason to regulate the Postal Service is that it a monopolist, with government-granted monopolies on non-urgent letter delivery and access to mailboxes. Without effective regulation, those dual monopolies would give the Postal Service the power to charge monopoly prices to customers trapped within its sheltered market.[25]

PRC Commissioner Ruth Goldway put it this way, "[O]ur nation cannot afford giving a monopoly provider substantial rate freedom. There has to be a trade-off in the form of reducing or eliminating the First-Class and letterbox monopolies" before rate regulation is substantially reduced. Commissioner Goldway said in the same vein that while "omnibus rate cases are time consuming," that is "a price we pay for due process." She also noted that the current regulatory system is more flexible than often acknowledged and described several ways to speed up rate cases while maintaining the present regulatory system and the protection it affords. She criticized the Postal Service because it "has been slow to take advantage of the rate flexibility that exists under current law."[26]

The regulator has often acted to hold back or to moderate rate increases. That is evident from recent rate cases. In the rate case the Postal Service filed in 1997, the Service initially wanted to raise rates in June 1997. The PRC, however, did not believe an increase was needed so soon and pushed the starting date back to January 1998. Moreover, based on its assessment of the Service's costs and revenue needs, the PRC reduced the requested rate increase by nearly one third. The PRC's restraining influence was especially evident with the Postal Service's flagship monopoly product: first-class mail. Compared to what the Service had requested, the PRC cut the average rate increase on first-class letters by 47% (from 3.2% to 1.7%), and it nearly eliminated the rate increase on first-class cards (from 5.9% to 0.2%).[27] In the rate case the Postal Service filed in 2000, the PRC reduced the average systemwide rate increase by 23% (from 6.0% to 4.6%). Concerned about the high price markup on first-class mail, the PRC cut the requested rate hike on first-class letters by 49% (from 3.5% to 1.8%), and the requested rate increase on first-class cards by 92% (from 5.2% to 0.4%).[28] The rate request filed in 2001 was exceptional because 9/11 and the anthrax attacks intervened. The parties in the rate case responded to the emergency by working out a settlement that the PRC approved.

In the 1997 and 2000 rate cases, the PRC concluded that the Service had overstated its revenue needs and ignored opportunities to trim costs and raise productivity. Although one should not take any credit anyway from Postmaster General John Potter and his management team, the significant cost savings they have achieved since 2001 while maintaining service standards vindicates the PRC's earlier conclusion that the agency could readily trim its projected cost increases. The evidence suggests that the PRC's unwillingness to rubber-stamp rate requests has exposed the Service to more financial discipline than would otherwise have been present and has held down rate increases, especially for mail users within the postal monopoly.

A less obvious, but also important, justification for regulation is the danger that the Service will use its governmental powers and income from its monopoly to subsidize uneconomic operations in competitive markets. That type of subsidization hurts monopoly-market customers; it threatens taxpayers; and it lowers the economy's productivity by substituting government production for more efficient private-sector production.[29] This danger is sometimes overlooked because a private-sector monopolist would not want to expand into markets where it expects to lose money since that would reduce its owners' profits. However, as a government-owned entity, the Postal Service lacks the financial discipline provided by the profit motive and may be attracted by the bureaucratic rewards that can be gained through mission creep and expansion.[30]

Although regulation is warranted, it does make sense to look for ways to improve the regulatory system while still providing adequate protection. Hence, it is regrettable that, as mentioned earlier, the Postal Service has been slow to adopt, and sometimes resisted, the opportunities already available under current laws and regulations to increase the flexibility and responsiveness of the regulatory process.

Rate-cap regulation makes good sense for private-sector businesses in regulated industries. For private-sector firms in regulated markets, rate-cap regulation should, in theory, be superior to traditional cost-of-service regulation. Rate-cap regulation is administratively simpler because prices can be adjusted just by looking at the inflation rate, a technology index, and perhaps making a few other adjustments, rather than having to examine and verify a regulated firm's costs.

More important, rate-cap regulation gives a regulated private-sector firm a stronger incentive to strive for efficiency. Under cost-of-service regulation, which is essentially cost-plus pricing, the motivation to lower costs is dulled because higher costs enter the rate base and can be passed along to ratepayers. An inefficient producer (with high costs and, thus, high allowed rates) can earn the same net income as a more efficient producer (with lower costs and lower allowed rates). Under rate-cap regulation, in contrast, allowed rates do not rise and fall with costs. Hence, the investor-owners of a private-sector regulated company will be rewarded with higher profits if they can discover ways to reduce costs while maintaining required service standards. Conversely, they will be penalized for high costs and low productivity: profits will suffer, owners' equity will decline, and the business may even go bankrupt in extreme cases.[31] These considerations have persuaded a number of states in recent years to move towards rate-cap regulation of private-sector enterprises in regulated industries.[32]

When price-cap regulation is applied to private-sector companies in regulated industries, a productivity adjustment factor is often subtracted from the inflation rate, which limits price increases to *less than* the inflation rate.[33] As mentioned earlier, the President's Commission envisioned rate-cap regulation at the Postal Service including such a technology adjustment, but H.R. 22 and S. 662 both lack that feature.

Rate-cap regulation is ill-suited to a government enterprise. The problem with trying to apply the rate-cap approach at a government enterprise such as the Postal Service is that government entities are primarily motivated by political and bureaucratic objectives rather than profitability. Rate-cap regulation can improve the performance of private-sector companies in regulated industries because it taps into the private-sector's profit motive. In contrast, the elected officials who authorize government enterprises and the government workers who manage them have little reason to be profit maximizers.

Although a government enterprise subject to rate-cap regulation can improve its bottom line if it somehow becomes more efficient, that does not directly reward those in the government who are involved with the enterprise. Similarly, lagging efficiency will worsen the bottom line of a government enterprise subject to rate-cap regulation, but that does not directly penalize elected officials and government workers. Because both the carrot and stick are lacking, shifting from cost-of-service regulation to rate-cap regulation will not magically create incentives at a government enterprise favoring greater efficiency and lower costs. What this means for the federally owned Postal Service is that moving to rate-cap regulation would, by itself, be unlikely to yield any significant improvement in the organization's long-term financial condition.

The President's Commission and others have suggested that rate-cap regulation would be an improvement if it is accompanied by well constructed performance incentives for Postal Service employees. However, that confuses two logically separate issues: performance incentives and the rate-setting process. If employee performance incentives are well designed, they would be beneficial. However, they would be just as helpful under cost-of-service regulation as under the rate-cap approach. The benefits would be due to the employee incentives, not the rate-setting regime. In practice, employee incentive programs have a mixed record at the Postal Service. The agency abandoned one major program several years ago after abuses came to light,[34] but it claims recent employee incentive programs have been better targeted and more successful. While employee performance incentives can be useful, they need to be monitored very carefully to protect the public, and that requires higher standards of transparency and accountability than are present at many government enterprises.

According to one commentator, many mailers hope that a rate cap would bolster the Postal Service's bottom line in another way, by persuading postal unions, the Service, and labor arbitrators to use the "inflation limit ... as a ceiling on wage increases."[35] Because almost 80% of the Services costs are labor related, such restraint would produce large cost savings over time and reduce the need for rate increases. However, this scenario, while it would be nice if it were true, is an exercise in wishful thinking. Labor unions and labor arbitrators are unlikely to conclude that a rate cap also places a cap on wages in the absence of explicit statutory language to that effect. Labor unions and labor arbitrators would be especially reluctant to interpret a rate cap as a de facto wage cap because, with few exceptions, H.R. 22 and S. 662 promise not to interfere with collective bargaining.[36] Rather than expecting a rate cap somehow to function as an indirect cost cap, a more realistic assessment is that if cost increases outstripped the rate cap, Congress would not let the Postal Service go bankrupt but would relax the rate cap and let rates rise with costs.

The prudent means of dealing with the Postal Service's high labor and other costs would be to pass legislation with stronger cost-control tools. That would not require any change in the rate-setting process.

Regulating Postal Service rates in competitive markets. As noted above, H.R. 22 and S. 662 adopt a minimalist approach towards rate regulation for Postal Service products in the competitive category. Provided a product's price covers its own costs and makes an adequate contribution to overhead, the Service could set almost any price it wants. The assumption underlying the bills' proposed regulation of the Postal Service's competitive-market pricing is that the agency tries to operate efficiently and profitably in competitive markets but is hamstrung by current price regulation. Supposedly, the Service would set prices in competitive markets based on efficiency and profitability considerations if only it had greater pricing freedom.

That assumption would be justified if the Postal Service were a private–sector business. One of the best-known findings in economics is that private-sector businesses, each setting prices with the goal of maximizing its own profits, are led under conditions of competition and pricing flexibility to an efficient market outcome.

However, the Postal Service is a government entity. It has goals and faces pressures that often conflict with efficiency and profitability. For instance, the Postal Service has an incentive to underprice its competitive-market products because operations beyond the core market may bring bureaucratic rewards, including greater power, prestige, and job opportunities for those within the agency. Relaxed rate regulation would make it easier for the Postal Service to underprice its competitive-market products.

The requirement in the proposed legislation that competitive products cover their own attributable costs and some overhead costs is supposed to insure that monopoly-market customers are not forced to subsidize competitive-market products. However, the lack of transparency in how the Postal Service allocates its costs undercuts that protection. The Postal Service claims that about 40% of its costs cannot be attributed to specific products and must be regarded as overhead costs. But comparisons with private-sector businesses and an examination of the specific items the Postal Service classifies as overhead suggest the Service is exaggerating overhead costs while lowballing attributable costs.[37] A significant overstatement of overhead costs and understatement of product-related costs would leave considerable room for hidden cross-subsidies. Most of these costs would be shifted to first-class mail users because first-class mail, which lies at the heart of the Postal Service's monopoly, bears a disproportionately high price markup and consequently pays a disproportionately high share of overhead costs.[38]

The possible presence of hidden cross-subsidies is already a concern under current law, and the threat would be greater under the looser rate regulation of H.R. 22 and S. 662. The underpricing of competitive-market products facilitated by rate-cap regulation would weaken, not strengthen, the Service's bottom line, as well as replacing some private-sector production with less efficient government production.

If flexible pricing will bring success, why are Amtrak and many airlines in such financial trouble? The notion that more flexible pricing is the key to creating a financially successful Postal Service also ignores the experiences of many companies that have had great pricing flexibility, but have done poorly. For example, United Airlines, US Airways, Bethlehem Steel, and Kmart are companies that enjoyed levels of pricing flexibility about which the Postal Service can only dream, but all landed in bankruptcy court. Those companies discovered that pricing flexibility is of little value when competitors better manage costs while maintaining product quality and, hence, are able to sell profitably for less.

Amtrak is another example. Amtrak is a government enterprise, but unlike the Postal Service it can change its prices without first going to a regulator. Amtrak has used that power to set rates it thinks appropriate on its various routes, to change those rates when it thinks it should, to provide weekly specials on certain routes at certain times, to offer discounts or package deals on trips to certain theme parks, exhibits, and events (such as the San Diego Rock ’n’ Roll Marathon[39] and the Broadway Show "Julius Caesar"[40]), to develop some advertised specials on very short notice (such as an "after the storms" discount on Florida travel following several hurricanes[41]), to charge some passengers (e.g., students, seniors, veterans, AAA members) less than other passengers, to offer discounts to people who use Amtrak frequently, to offer an Amtrak guest rewards program with points that can be redeemed for Amtrak travel, and in other ways to vary prices so as to respond actively and quickly to market conditions and changes in market conditions.

Has that pricing flexibility enabled Amtrak to succeed financially? No. In fact, it probably hurt. The Department of Transportation reported that although "Amtrak’s systemwide ridership increased to record levels in 2003," its operating revenues actually declined, "*primarily because of promotional fares and selected fare reductions on the long-distance trains* as well as the termination of the commuter contract with the Massachusetts Bay Transit Authority... [Emphasis added.]"[42] Apparently Amtrak used its pricing flexibility to cut fares too aggressively. That pushed up sales but cut into revenues.

Amtrak, with its pricing flexibility, has a bottom line that is much worse than that of the Postal Service. The Department of Transportation reported that in fiscal year 2003 Amtrak incurred an operating loss of $1.3 billion.[43] Further, its operating loss has exceeded $1.1 billion in each of the last 3 years, and has topped $750 million in each of the past 10 years.[44] In Congressional testimony in 2003, Allan Rutter, the Federal Railroad Administrator, testified that Amtrak’s 43 regularly scheduled routes were all losing money when depreciation and interest are included in costs, with the loss on long distance trains ranging "from $131 per passenger to $551 per passenger."[45] The government-owned intercity passenger railroad would long since have gone bankrupt if it were not, in effect, part of the federal government, from which it has received tens of billions of dollars of cash infusions. (Bankruptcy is being talked about now, though, in response to an Administration proposal to reduce Amtrak’s federal appropriation for fiscal year 2006.) Amtrak also receives an assortment of hidden government subsidies via tax and fee exemptions and other government-granted privileges.[46]

Amtrak’s experience also provides a powerful counterexample to the hope that pricing flexibility will somehow motivate a government enterprise to achieve high service standards. Amtrak’s service is plagued with delays. In fiscal year 2003, even its premier train, the supposedly high-speed Acela, managed to stay on schedule only "74.7 percent of the time, with average delays of 54 minutes."[47] Worse, since mid-April of this year, Amtrak’s Acela trains have been sidelined because of a safety problem with their brakes.[48] The Transportation Department has warned that a growing backlog of unmet maintenance needs "brings Amtrak closer to a major point of failure on the system."[49]

The lesson here is that pricing flexibility is of little assistance if a producer has high costs, poor service, or products that customers do not value for other reasons.

Current rate regulation improves transparency. An often overlooked benefit of the current rate-setting process is that it helps shine light on the Postal Service’s finances and operations. Those who deal with the government agency have often found that it is more forthcoming with information during rate cases than at other times. In part, this is because rate hearings are formal proceedings and include a discovery process. It also reflects incentives. Because the Postal Service is asking the PRC for something during a rate case (approval of a rate request), the Service tends to be more cooperative at that time.

Even a within-government watchdog with the expertise and muscle of the Government Accountability Office (GAO) finds that the disclosures elicited during rate cases are a valuable information source. For example, in January 2004 testimony to Congress, David Walker, the head of GAO, mentioned that he obtained Postal Service data from multiple sources, including some "produced ... by stakeholders participating in rate cases."[50]

The fewer and briefer hearings that would occur under H.R. 22 or S. 662 would produce much less information. The flow of information would diminish both because the PRC and interested parties would have less time and opportunity to ask questions and because the Postal Service would have less need to cooperate. This is contrary to the reform goal of improving transparency and accountability.[51]

The Postal Service favors a non-binding rate cap. Although the Postal Service prefers rate-cap regulation to current rate regulation, its officials have often expressed doubts about being able to live within a price cap. For example, Mr. Fineman told Congress in 2004 that a price cap should not be rigid but should permit "special relief in exigent circumstances."[52] Postmaster General Potter explained that the Service is worried about costs and fears a rate cap would be unworkable if it holds rate increases below cost increases. In 2004, he warned against a conventional price cap based on the CPI, and, while still using the term "price cap", called instead for a cap based on the Postal Service's *costs*.

> [T]he success of a price cap is entirely dependent on its ability to accurately project and reflect postal costs during the covered period. We believe the appropriate price cap ... would be made up of at least four components: a fuel index, a network expansion index, the actual growth in statutory benefits, and ECI wages [a wage index].[53]

In effect, this would be disguised cost-of-service regulation but with less regulatory oversight than current law provides. Mr. Potter related his concern to a major weakness of congressional bills H.R. 4341 and S. 2468 (repeated in this year's H.R. 22 and S. 662): they would give the Postal Service few new cost-control tools. He said, "Since *neither bill provides the opportunity for relief from our major cost drivers - wages and benefits* - we believe any price cap index must take all cost drivers into consideration. [Emphasis added.]"[54]

In early 2005, the Postal Service's Governors moderated the Service's position. Noting that postal rate increases have "[h]istorically" not exceeded the CPI, the Governors wrote. "We believe that CPI would be an acceptable, albeit very challenging, price cap on rates..."[55] The reference to the historical record suggests the Governors have decided a CPI rate cap would probably be feasible because it would not require the Service to do any better in the future at holding down rate increases than it has in the past.

The emphasis the Postal Service places on costs should give pause to those who would make rate-cap regulation the centerpiece of Postal Service "reform". The Service is basically saying that shifting to rate-cap regulation would, by itself, do little to strengthen the Postal Service financially. The Service regards cost increases as the prime driver of price increases. Based on statements like those cited above, the agency does not think that rate-cap regulation would appreciably slow cost increases and, therefore, the need for price increases. The Service's doubts about a tight rate cap also indicate it is skeptical of the fiscal discipline argument mentioned earlier, whereby a tight rate cap would supposedly instill greater fiscal discipline within the Postal Service ("maximize incentives to reduce costs and increase efficiency" in the words of H.R. 22 and S. 662[56]), restrain unions and labor arbitrators, and provide a shield to deflect Congressional objections when the Service takes politically unpopular steps to cut costs.

If the Postal Service believes it would have difficulty complying with a rate cap, it is acting responsibly in telling Congress that it foresees a problem; a government agency should not give financial assurances to Congress that the agency does not think are realistic. However, the Postal Service's vigorous denials that rate-cap regulation would afford the agency a significant financial boost raise questions as to why the agency has pushed so hard over the years to replace the current regulatory system and claimed so vehemently that the current system is extremely costly and cumbersome.

In now denying that rate-cap regulation would help much with costs, the Service is essentially saying that its current regulatory compliance costs are small potatoes compared to its other costs. A reasonable question is whether the Service's vehement and long-standing complaints about the rate-setting process are not directed at the current system but at rate regulation itself. In other words, is the Service's true objection to the existence of an independent federal regulator that watches the Postal Service closely, asks sometimes embarrassing questions, and participates in rate-setting decisions?

Conclusion. An alluring notion is that the Postal Service could attain much of the efficiency and enterprise of a private-sector business if only it were subject to less rate regulation. Allowing more pricing discretion, however, would not have the desired effects both because the Postal Service is a monopolist and because it is owned by the government rather than profit-motivated shareholders. Instead of promoting efficiency, looser rate regulation would increase the dangers that the Service will overcharge customers within the postal monopoly while overexpanding and charging too little in competitive markets. Looser rate regulation would also tend to reduce transparency at the government-owned enterprise.

Most of those who support rate-cap regulation are genuinely concerned about the Postal Service's health. They are attracted to rate-cap regulation because they believe it would be politically feasible, would produce a stronger and more efficient Postal Service, and would adequately protect mail users and the economy. The reality, however, is that rate-cap regulation is not an elixir. It would not deal with the Postal Service's basic problems, and would be inferior to current law in safeguarding mail users and the economy.

Legislation that adopts a new, looser system of rate regulation will yield disappointing results unless it contains strong reforms in other areas. To help the Postal Service financially while protecting the agency's customers and assisting the overall economy, the essential features of genuine reform legislation should be giving the Service better tools to manage its costs, requiring it to meet higher standards of transparency and accountability, and insisting that the agency eschew mission creep and focus on the core services delineated by its dual monopolies.

Michael Schuyler
Senior Economist

This is another of a continuing series of IRET papers examining the U.S. Postal Service. IRET began its work in this area in the mid 1990s. Norman Ture, the organization's founder, believed that growth and prosperity are advanced by restricting government to a limited set of core functions. From this perspective he was concerned about the activities of government owned and sponsored businesses. The Postal Service stands out among government businesses because of its size — it employs nearly one third of the federal government workforce — and its efforts over the years to expand.

Endnotes

1. H.R. 22, Title II, and S. 662, Title II.

2. See President's Commission on the United States Postal Service, *Embracing The Future; Making The Tough Choices To Preserve Universal Mail Service*, July 31, 2003, esp. pp. 56-62, 72, accessed at http://www.treas.gov/offices/domestic-finance/usps/pdf/report.pdf. A previous paper in this series more fully discussed the Commission's findings and its recommendations. See Michael Schuyler, "Presidential Postal Commission Recommends Cost-Control Reforms, Not Business Expansion," *IRET Congressional Advisory*, No. 160, October 16, 2003, available at ftp://ftp.iret.org/pub/ADVS-160.PDF.

3. For a thorough side-by-side guide to what is in the bills, see Kevin R. Kosar "Postal Reform Bills: A Side-by-Side Comparison of H.R. 22 and S. 662," Congressional Research Service, Order Code RL32903, May 12, 2005.

4. See PL 91-375, Postal Reorganization Act of 1970, August 12, 1970, chapter 36, codified in 39 USC, chapter 36.

5. One clear exception is that the Postal Service can set international mail rates without having to ask the PRC for approval. In addition, 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 retail merchandise sold in post office lobbies, greeting cards sold from the Postal Service's Website, and an international wire transfer service.

6. Congress added the 10 month time limit in 1976 to insure that cases would be resolved in what Congress deemed to be a reasonable time period.

7. 39 USC, Sec. 3622. A major problem for the PRC in attempting to enforce this statutory requirement is that per-product costs are calculated based on data that the Postal Service collects, using estimation techniques that the Service largely chooses. Does the Service collect the most relevant data and use techniques that accurately estimate per-product costs? The Service is resisting PRC demands for greater transparency in this area. For a fuller discussion of the Service's frequent demands for secrecy and why the transparency sought by the PRC would be sound public policy, see Michael Schuyler, "Should the Postal Service Be Able To Withhold Some Of Its Financial Results From The Public?" *IRET Congressional Advisory*, No. 184, March 16, 2005, available at ftp://ftp.iret.org/pub/ADVS-184.PDF.

8. "Postal rates and fees shall provide sufficient revenues so that the total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs of the Postal Service." (39 USC, Sec. 3621.) This is also called the break-even requirement.

9. 39 USC, Sec. 3625. The Service's occasional use of this power increases its leverage in rate cases.

10. For a fuller discussion, see Michael Schuyler, "Is The Postal Rate-Setting Process Broken?" *IRET Congressional Advisory*, No. 182, December 8, 2004, available at ftp://ftp.iret.org/pub/ADVS-182.PDF.

11. See Michael Schuyler, "Should the Postal Service Be Able To Withhold Some Of Its Financial Results From The Public?" *op. cit.*

12. This characterization is slightly oversimplified because the bills include in the market-dominant category some products that face strong and direct private-sector competition. For example, postal money orders are on the market-dominant list (under special services) in both bills despite vigorous financial sector competition, and single-piece parcel post is on the market-dominant list in the Senate bill. (See sec. 201 of H.R. 22 and S. 662.) Such products should be on the competitive list, given the presence of close private-sector substitutes that customers frequently use. In addition, the Postal Service dominates some product niches not because of its dual monopolies but because its prices have been set very low as a matter of government policy. Media mail and library mail are two examples, and both are on the market-dominant list.

13. Sec. 201 of H.R. 22 and S. 662. The Postal Service's regulator, which would be reorganized as the Postal Regulatory Commission, would first set rates based on a number of statutory considerations. The Postal Service could thereafter generally change the rates as long as they stayed within the inflation cap. Technically, S. 662 says that the Service would have to give 45 days notice before a rate change became effective, and the PRC could review the proposed change during that period to be sure it stayed within the CPI cap. In H.R. 22, the regulator could choose the method of rate regulation, subject to the restriction that it would have to provide "notice and opportunity for a public

hearing and comment" if a proposed increase exceeded the CPI. It is widely believed that if H.R. 22 became law the regulator would establish a quick approval process for rate increases not exceeding the CPI.

H.R. 22 specifies that the inflation cap would apply separately to each subclass of mail. This means that rates on some mail within the subclass could increase *more rapidly* than the CPI provided the average rate increase within the subclass did not exceed the CPI. S. 662 has a looser rate cap in this respect. It specifies that the inflation cap would apply separately to each class of mail, which can include multiple subclasses. Hence, S. 662 would allow rate increases on some products, and even whole subclasses of mail, to rise *faster* than the CPI, provided the average rate increase within the class did not exceed the CPI.

14. See sec. 201 of H.R. 22 and S. 662.

15. Sec. 202 of H.R. 22 and S. 662.

16. United States Postal Service, *United States Postal Service Transformation Plan*, April 2002, p. x, accessed at http://www.usps.com/strategicdirection/transform.htm.

17. "Review of pricing and classification should be conducted through a complaint process." (*Ibid*.)

18. "Outside the scope of the monopoly, pricing should be regulated under the antitrust and fair competition laws applicable to other businesses." (*Ibid*.)

19. 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 at http://www.usps.com/communications/news/speeches/2003/ sp03_pmg0529.pdf.

20. David Fineman, Chairman, U.S Postal Service Board of Governors, Statement, Before the Special Panel on Postal Reform and Oversight, House Committee on Government Reform, 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 at http://a257.g.akamaitech.net/7/257/ 2422/07jun20041300/www.access.gpo.gov/congress/house/pdf/108hrg/93087.pdf.

21. *Ibid.*, pp. 38-39.

22. Ann S. Moore, Chairman and Chief Executive Office, Time Inc., Testimony, Before House Committee on Government Reform, Special Panel on Postal Reform and Oversight, February 11, 2004, accessed at http://reform.house.gov/UploadedFiles/Time%20-%20Moore%20Testimony.pdf.

23. *President's Commission*, *op. cit.*, p. 57.

24. See Robert A. F. Reisner, Global Insight "Price Caps and the US Postal Service; Prospects, Perils and the Public Interest," Consulting project for the President's Commission on the United States Postal Service, 2003, accessed at http://www.treas.gov/offices/domestic-finance/usps/docs/may_26_paper3.pdf.

25. The Postal Service's monopoly power is not absolute. There are indirect substitutes for hard-copy mail, such as telephone calls, faxes, private-sector express delivery, and e-mails. Moreover, the Postal Service has less monopoly power than it did 10 or 15 years ago because of households' and businesses' growing familiarity with electronic alternatives to hard-copy mail. Nevertheless, if one wants to send a hard-copy, non-urgent letter or place an item in a mailbox, the Postal Service is the only game in town as a result of the federal statutes barring direct competition in those areas.

26. All quotes in this paragraph from Ruth Y. Goldway, Commissioner, Postal Rate Commission, "Comments To The President's Commission On The United State Postal Service," February 3, 2003, accessed at http://www.postcom.org/ public/2003/goldway_statement.htm. Goldway thinks the best way simultaneously to promote a more dynamic mailing industry and better protect postal consumers would be to demonopolize and privatize the Postal Service. She believes the resulting increases in competition and market vibrancy would benefit postal consumers far more than the present combination of monopoly, government ownership, and regulation. Her recommendations for freeing the postal market, however, do not have much political support currently.

27. See Postal Rate Commission, *Opinion And Recommended Decision*, vol. 1, Postal Rate and Fee Changes, 1997, Docket No. R97-1, vol. 1, May 11, 1998, pp. ii-iii, accessed at http://www.prc.gov/docs/8/8043/ R97-1V1.PDF.

28. See Postal Rate Commission, *Opinion And Recommended Decision*, vol. 1, Postal Rate and Fee Changes, 1997, Docket No. R97-1, vol. 1, November 13, 2000, pp. ii, accessed at http://www.prc.gov/docs/26/26350/R2000-1-V1-Rev.pdf. As a note, the PRC later reconsidered its decision at the Postal Service's request and approved larger rate increases for bound printed matter and certified mail than it had initially recommended.

29. For a fuller discussion of this hazard, see Michael Schuyler, "Empire Building At The Postal Service," *IRET Policy Bulletin*, No. 87, May 19, 2003, accessed at ftp://ftp.iret.org/pub/BLTN-87.PDF.

30. For an economic and legal analysis comparing the rewards, penalties, and restrictions faced by state owned enterprises and private-sector companies, see David E. M. Sappington and J. Gregory Sidak, "Competition Law for State-Owned Enterprises," *Antitrust Law Journal*, vol. 71, no. 2, 2003, pp. 479-523, accessed via http://papers.ssrn.com/sol3/papers.cfm?abstract_id=357720. Researchers Sappington and Sidak concluded that a government enterprise has a "greater incentive and ability to price below cost" than does a private-sector business. (*Ibid.*, p. 485.)

31. In practice, the regulator may recalibrate rates after several years and make some adjustments for actual costs at that time. Hence, the gains from superior efficiency (and losses from inferior efficiency) may persist for several years, but not be permanent. Still, several years of gains or losses can be a strong pro-efficiency incentive.

32. For a sketch of changes at the state level in rate-setting procedures applied to regulated telecommunications companies, see David Sappington, "Pricing of Regulated Retail Services in The Telecommunications Industry," prepared for the President's Commission on the United States Postal Service, accompanying testimony delivered on February 20, 2003, accessed at http://www.treasury.gov/offices/domestic-finance/usps/testimony-docs/Sappington.pdf.

33. For example, if the inflation rate is 3% and technology is expected to reduce costs by 0.5% yearly, the limit for rate increases would be 2.5% yearly.

34. See Office Of Inspector General, U.S. Postal Service, "Use of the Economic Value Added Concept in the Pay for Performance Program," Report No. LH-AR-02-001, December 5, 2001, accessed at www.uspsoig.gov/foia_files/LH-AR-02-001.pdf; Office Of Inspector General, U.S. Postal Service, "Economic Value Added Variable Pay Program," Report No. LH-AR-02-001, July 31, 2000, accessed at www.uspsoig.gov/foia_files/ LB-AR-00-001.pdf; Rick Merritt, "Stamping Out Productivity," *Washington Times*, January 9, 2002, p. A17; and Charles Guy and Michael Paranzino, "Postal Management To Receive Bonuses Despite The Inspector General Finding That The Formula Is Inappropriate," Lexington Institute, *Issue Brief*, December 14, 2001, accessed at http://www.lexingtoninstitute.org/ postal/mgtbonuses.htm.

35. See Cary H. Baer, "Reform: I Don't Get It," *DM News*, July 1, 2004, accessed at http://www.dmnews.com/cgi-bin/artprevbot.cgi?article_id=29335. Mr. Baer is personally doubtful that a rate cap would lead to wage restraint. He calls for statutory reforms in the determination of compensation.

36. See H.R. 22, sec. 405 and S. 662, sec. 505, both titled "Noninterference with collective bargaining agreements."

37. For some cases in which overhead costs appear to be exaggerated, see Michael Schuyler, "Uneven Price Markups Distort Postal Service Mission," *IRET Congressional Advisory*, No. 165, December 11, 2003, p. 7, available at ftp://ftp.iret.org/pub/ADVS-165.PDF.

38. The markup on a product, which is usually expressed as a ratio, refers to the amount by which the product's price exceeds the costs attributable to that product. For a discussion of the Postal Service's unequal price markups and how the very high markup on first-class mail conflicts with the agency's government-assigned function, see Michael Schuyler, "Uneven Price Markups Distort Postal Service Mission," *IRET Congressional Advisory*, No. 165, December 11, 2003, ftp://ftp.iret.org/pub/ADVS-165.PDF.

The argument is sometimes made that first-class mail should bear an especially heavy markup because its demand is relatively insensitive to price. Under some circumstances it can be efficient to place higher markups on price-insensitive products. However, first-class mail's inelastic demand is artificial in the sense that it springs from the Postal Service's monopoly and the resulting lack of direct competition. Given that the government claims the monopoly is part of a package to provide everyone with reasonable mail service at affordable prices, it is a clear abuse of monopoly power and directly contrary to the agency's governmental mission to then use the inelastic demand resulting from the monopoly as an excuse for pushing up first-class mail rates.

39. Seehttp://www.amtrak.com/servlet/ContentServer?pagename=Amtrak/am2Copy/Hot_Deals_Page&c=am2Copy&cid=1093553986325&ssid=224, accessed on March 29, 2005.

40. See http://www.amtrak.com/servlet/ContentServer?pagename=Amtrak/am2Copy/ Hot_Deals_Page&c=am2Copy&cid=1093553989530&ssid=224, accessed on March 29, 2005.

41. See http://www.amtrak.com/servlet/ContentServer?pagename=Amtrak/Page/ Hot_Deals_Index_Page&c=Page&cid=1080072922226&ssid=8, accessed on October 29, 2004.

42. Kenneth M. Mead, Inspector General, U.S. Department of Transportation, "Assessment Of Amtrak's 2003 and 2004 Financial Performance And Requirements," Report No. CR-2005-013, November 18, 2004, pp. 4, accessed at http://www.oig.dot.gov/StreamFile?file=/data/pdfdocs/cr2005013.pdf.

43. *Ibid.*, p. 2.

44. *Ibid.*, p. 8, Fig. 1.

45. Allan Rutter, Administrator, Federal Railroad Administration, U.S. Department of Transportation, "Statement of Allan Rutter," before the Subcommittee on Railroads, House Committee on Transportation and Infrastructure, April 30, 2003, accessed at http://www.house.gov/transportation/rail/04-30-03/rutter.pdf.

46. For rough estimates of the dollar magnitude of some of Amtrak's hidden subsidies, 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).

47. William Glanz, "New Strategy Urged For Amtrak," *The Washington Times*, November 21, 2004, accessed at http://washingtontimes.com/business/20041121-105657-5193r.htm.

48. "Amtrak: Life Expectancy Of Acela Brakes Overestimated," *USA Today*, April 27, 2005, accessed at http://www.usatoday.com/travel/news/2005-04-27-acela_x.htm.

49. Mead, *op. cit.*

50. U.S. General Accounting Office, "Key Elements of Comprehensive Postal Reform," Testimony of David M. Walker, Comptroller General of the United States, Before the Special Panel on Postal Reform and Oversight, House Committee on Government Reform, p. 4, January 28, 2004, accessed at http://www.gao.gov/new.items/d04397t.pdf.

51. H.R. 22 and S. 662 are complicated bills, and they have other provisions that would also affect transparency and accountability, some positively and some negatively. This is not the place to examine all those provisions. The point here is that whatever else is in the bills, the rate-setting process proposed in H.R. 22 and S. 662 would have a negative impact on transparency and accountability compared to the current rate-setting process.

52. David Fineman, Chairman, Testimony before House Committee on Government Reform, January 28, 2004, *op. cit.*.

53. John E. Potter, Postmaster General/CEO, U.S. Postal Service, Testimony, Before a Joint Hearing of the House Committee on Government Reform and the Senate Committee on Governmental Affairs, March 23, 2004, accessed at http://reform.house.gov/UploadedFiles/USPS%20-%20Potter%20Joint%20Testimony.pdf.

54. John E. Potter, Postmaster General/CEO, U.S. Postal Service, Remarks at New England Mail Expo, May 26, 2004, accessed at http://www.usps.com/communications/news/speeches/2004/sp04_0526pmgpcc.htm.

55. U.S. Postal Service Governors, "Letter to Senator Susan M. Collins," Chairman, Senate Committee on Homeland Security and Governmental Affairs, February 24, 2005, accessed at http://www.postcom.org/public/2005/Scan058,%20February%2024,%202005.pdf. A similar letter was sent to those in the House involved with Postal legislation.

56. Sec. 201 of H.R. 22 and S. 662.
