

COMMENTS TO THE PRESIDENT'S COMMISSION ON THE
UNITED STATE POSTAL SERVICE
SUBMITTED BY
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OVERVIEW

From my vantage as a commissioner at the Postal Rate Commission I have concluded, as have many others, that the current regulatory model does not work. But I do not think it has ever worked particularly well. Examples of chronic productivity inefficiencies are legion. From a consumer perspective, I would note that First-Class service has deteriorated over the years, while First-Class mail pays an ever-increasing share of overhead. Flexibility in rate setting without other structural changes including increased regulatory oversight will only worsen the problem.

The positive results we have seen from recent Postal Service financial reports are being achieved despite a law that grants a nationwide monopoly and provides very little incentive for efficiency. The Postal Rate Commission, the sole regulator, has limited powers. With no subpoena authority, it can obtain only incomplete information on which to base its recommended decisions. The Commission cannot direct organizational change to lower costs. When postal costs rise - regardless of the cause - we must recommend rates to cover the increased costs.

¹ These views are my own and do not necessarily represent the views of the Commission.

The current law provides only weak protection for household or business mailers. There is virtually no recourse or restitution when the Postal Service fails to meet its service commitments. And Postal Service product design and advertising can leave consumers confused about the best mailing options available.

I agree that the Postal Service does not have the ability to change rates or products fast enough to meet competition or adverse economic conditions. However, the Postal Service has been slow to take advantage of the rate flexibility that exists under current law. I would also caution that our 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. I am disappointed that the Postal Service does not concede this to be the case in its Transformation Plan.

One may ask, if the law is inadequate in providing efficiency incentives, how does one account for the Service's recent cost-cutting successes? Paradoxically, these changes have been in reaction to competitive forces that are just beginning to erode the monopoly. The computer revolution, especially electronic billing and e-mail, offers more convenient, less expensive and better quality alternatives to major mailers and household consumers than existed just a few years ago.

But we cannot rely exclusively on the indirect competition that is developing from technology. In the long run, the Service needs to be privatized and the letter and letterbox monopolies phased out. The best-intentioned laws

cannot provide the incentives and creative vigor that a competitive market does. As I detail below, the “universal service” and “natural monopoly” arguments used to justify the monopoly do not withstand scrutiny. Even if one thinks local delivery has natural monopoly elements, this does not mean delivery competition should be eliminated. Local governments could be given the authority to decide who can provide the best and cheapest mail delivery service in their jurisdiction, at a level of service their citizenry asks for. This is an example of democracy and capitalism working in sync to reach the best possible outcome for consumers.

In its Transformation Plan, the Postal Service suggests reform should take the form of a government-sponsored enterprise, or GSE, though the plan is not at all clear about the structure a GSE should take. GSEs have many downsides, including potential governmental liabilities. While some say we need a governmental presence in the postal industry, communications services critical to our well being such as the Internet, telephone, and television are privately owned.

Nor can one identify any market failure that would justify a GSE. A GSE may be justified where the private sector would not provide a good or service, but our parcel and expedited mail markets are examples of network-type mailing industries that need little regulation and no special government support. If a GSE is recommended, it should be one that provides for a fixed transition to demonopolization and privatization.

My greatest fear is that special interests will construct a GSE providing benefits for only the few, such as: (1) high salaries for postal executives which

are unconstrained by meaningful shareholder review; (2) retention of the monopoly on a permanent basis; (3) no plan for moving towards privatization; (4) special rate deals for a few large mailers; and (5) an even weaker regulator.

Meanwhile, I believe there are important reforms this commission should consider recommending that would assist the Postal Service without giving it the expansion of ratemaking authority and continued monopoly suggested by the Transformation Plan. Briefly, Congress needs to remove itself from day-to-day postal operations and allow the PMG and the Governors to make significant institutional reductions. The current pay system for USPS executives needs fundamental change. The Service should be required to develop service standards for all mail classes, not just First Class, and report regularly and publicly on how well it meets those standards. Its advertising needs to be governed by the truth-in-advertising laws enforced by the Federal Trade Commission. Its retail operations need to be expanded even more quickly through joint ventures with the private sector. Retail service adjustments may involve closing many post offices, but will benefit the public if other choices the Postal Service provides are cheaper, more accessible to reach, and open longer hours.

The USPS needs to identify opportunities for contracting out some of its operations requiring high levels of expertise widely available in the private sector, e.g., contracting out its real estate operations. (I do not mean substituting cheap labor for union jobs.) And whether or not we continue with the current ratemaking system and monopoly protection, the postal regulator needs

subpoena power to ensure the best data is made available for its decisionmaking.

Below is some elaboration on my ideas as well as further criticism of the USPS Transformation Plan and the current regulatory scheme.

The current law never has worked very well. Beware of the nostrum that we just need to fine-tune a law that worked well until now. Here is just one example that debunks the myth that the current system was not broken until recently. Did you know that the average delivery time for First Class letters is slower than it was two decades ago? The average delivery time for a First-Class letter was 1.86 days in the fourth quarter of Postal FY2002. For the same quarter in 1981 (the earliest Commission records) the average was 1.57 days.

But under current law we cannot effectively penalize the Postal Service when service deteriorates for a particular mail class. While we can lower rates for the class where service is poor, that may unfairly penalize other subclasses, since someone has to pay the institutional bills.

I can regale you with many stories about inefficiency; about executives being given large bonuses even when the bottom line was terrible, and the workers who actually processed and hauled the mail got no bonuses in good or lean years; about a flats mechanization program that for years was *increasing* the unit cost of processing flats; about non-productive labor time (breaks, clocking-in, etc.) in mail processing escalating from 6.2 percent of direct labor costs in 1969, the year before postal reorganization, to 31.4% in 1996.

Overall, the Service has not been a model of efficiency because the current law does not provide the right incentives. There is a measure of efficiency called Total Factor Productivity, or TFP, that in varying forms is used to measure productivity across all industries. Until the last few years the Postal Service's TFP trailed the private sector's increases badly. We have seen some spurts in TFP recently, but the jury is out on whether this will last. Similar spurts in the past caused solely by reducing staff were temporary. In each of these cases service deteriorated and the Postal Service was forced to hire more workers. Fundamental operating reforms never occurred. I hope what we have been seeing since 9/11 is the start of a comprehensive efficiency program, blessed by Congress (at least by congressional silence), in which unnecessary facilities are cut and the Service takes maximum advantage of new technologies.

What does current ratemaking law have as an answer to respond to the high costs and myriad losses caused by inefficiencies? The PRC is required to give the USPS more money. The Postal Service has found that, even if the big mailers balk, one can always get money from the captive First-Class mailers. And after the PRC considers all future predicted and explained cost increases, and accounts for them in recommending higher rates, we still have to give the Service a further amount – a contingency -- for unexpected occurrences. Typical amounts are in the range of one-and-a-half to four percent above projected revenue needs. Billions of “contingency” dollars since 1970 have simply been absorbed into the fat of the system because the Service spends this money on everyday operations rather than “unexpected occurrences.” If the contingency

requirement had been working, when the Postal Service endured the anthrax crisis it would not have had to go to Congress for money to recoup expenses. It should have had a rainy day fund built up from all the contingency money given to it over the years.

The current law does not protect consumers well. After serving on the Commission for a year, I wrote an op-ed piece for *USA Today* demonstrating that consumers were paying a premium for a service – Priority Mail – that had about the same delivery times as First-Class letter mail. The basic rate for Priority Mail is about ten times more expensive than for First-Class. Priority Mail has been just one chronic problem area. In the last contested rate case our Commission expressed discontent with the state of special services, such as certified mail. Service choices are confusing, and some of the promised service features are not carried out well. Our Office of the Consumer Advocate issued a report in 2002 that pointed out a number of long term service problems. We are reading a growing number of press reports reciting consumer complaints about late-evening deliveries and long lines at some postal windows. These worry me because of the Service's history in cutting personnel to achieve temporary efficiency gains. Under current law our Commission can only identify these problems in our rulings and hope someone in postal operations sees our concerns and acts on them.

Moreover, the Postal Service enjoys legal advantages private sector companies do not. Consumers are sometimes rudely surprised to learn that they

are bound by a bulky volume of postal regulations that often reduces their rights. For example, if you buy insurance when mailing a parcel you are governed by a list of exclusions that is not widely published. Private sector businesses do not have the advantage of being able to keep the contractual terms under which they do business buried in a thick volume under the counter. The Postal Service says it wants to run itself like a private business, but it is quick to clothe itself in governmental legal immunities when it faces legal challenges.

First-Class single-piece mail rates, the ones you and I use to mail letters and pay our bills, have stayed even with inflation since 1970. Is that progress? As I stated, the small-volume First-Class mailer is paying an ever-increasing share of the Service's overhead costs. We'd like to reduce the Postal Service's dependency on the "Aunt Minnie" ratepayer, but, e.g., advertisers can use other media, so they can demand lower rate increases.

There are two sides to the rate flexibility story. Yes, the Postal Service needs rate flexibility. It is commonly known, for example, that its competitors offer secret discounts off published rates.

However, economic theory states that giving more rate flexibility to a regulated monopolist carries with it significant and often unacceptable downsides. The monopolist may try to cross-subsidize its competitive ventures with revenues gained from its monopoly services. Further, freed from "undue discrimination" legal restraints, the Service would be able to pick winners and losers among its customers. This would in turn affect competition in its

customers' markets and affect overall consumer welfare. Ultimately the household and small business ratepayers will be the ones squeezed most severely.

In a model where the Postal Service has fewer (or even no) regulatory ratemaking constraints, one solution is to balance increased rate making freedom with a strengthened regulatory agency empowered to act on quality of service and consumer issues, and to impose a progressive diminution of the monopoly until total phase out occurs. A firm deadline for ending the monopoly will provide the USPS with a major incentive for making its operations more efficient.

Under current law omnibus rate cases are time consuming, a price we pay for due process. But the Service fails to mention that it can file niche classification cases, or cases involving narrowly focused rate changes, that may take little time. It has filed few experimental cases over the years. I was disappointed in the position of USPS staff during the postal ratemaking summit; they almost uniformly dismissed what I thought were interesting, worthwhile ideas on how to simplify the ratemaking process, such as separating rate cases from methodology and classification cases. Such a reform might make ratemaking into a fairly quick exercise of plugging updated cost data into a formula. I think the Postal Service needs to bring in consultants to study the issue objectively rather than rely on a staff comfortable with the status quo.

Paradoxically, current Postal Service increases in efficiency are being driven by competition. I lived in Finland where they have no paper

checks. Eventually we will come close to their system. Other sources of mail also will dry up. Paper airline tickets are a rarity. The federal government has been trying to reduce mailing costs substantially, e.g., direct deposits of payroll and pension checks. Treasury is trying to get us to file our tax returns electronically.

These trends are good for our nation as a whole – paper checks are very costly (more than a dollar each) for society to process. Such cost cutting will make the U.S. more competitive. But it is bad news for the Service. First-Class mail, which provides most of the financial support to the USPS, is on the wane.

PMG Potter's efforts to cut costs seem to be working. In the latest accounting period revenues were up 6% over the same period last year (SPLY), largely thanks to last year's rate increase. Almost without precedent, total expenses were down almost one percent, and total work hours were down 4.3% over SPLY. But more work needs to be done. We all await detailed plans (not just the promises) to consolidate facilities and close unnecessary facilities. It is important for Congress not to interfere with these efforts, and to recognize that consumers as a whole will enjoy the benefits of lower costs.

Eventually, demonopolization and privatization are the answer. To make the Postal Service truly efficient, it eventually needs to lose its monopoly protections and be privatized, as I stated over three years ago in a *Washington Post* op-ed. Privatization introduces new incentives for efficiency, including the incentive to lower costs. It reduces political interference in decisionmaking,

which has been a past problem in the postal area. Crucially, it enables capital markets to discipline management. Privatization also is a means for the U.S. Government to recover the assets it gave away for free in 1970 to the current postal corporate entity. In a sense, those assets have been parked in escrow while the USPS has been given free use of them. Moreover, a privatized company would pay federal and state taxes, which the USPS does not. I just read of a Minnesota community, Arden Hills, that stands to lose \$488 million in taxable market value of prime commercial real estate if the Postal Service is allowed to take title for a processing and distribution center.

The USPS First-Class mail and letterbox monopoly protections are not needed. The basic theory used to justify them holds that natural monopolies need protection or else wasteful competition will occur, e.g., two carriers serving the same street where one would do. There is increasing and persuasive evidence that postal services are not natural monopolies. The Postal Service has found that private sector transportation companies can move the mail better and more cheaply and so primarily uses contract services. As to mail processing, many private sector companies do mail consolidation, sorting and drop shipping to profit from work sharing discounts. To the extent these operations exist, they are examples of someone doing it better and cheaper than the Postal Service.

The Postal Service faces strong competition in the parcel and expedited mail delivery markets from several private companies that traverse the same roads and have widespread delivery networks. One of its chief rivals is highly

unionized. And its service can be considered universal. Yet I read nowhere in the Transformation Plan any acknowledgement that competition works well in these markets. Why are not these “natural monopolies?” It could be that we have been misled about the need for the First-Class monopoly. After all we have not needed monopoly protection laws to enable buying food, gasoline, prescription drugs and other vital commodities in all areas of our nation.

There is good evidence that universal service would continue under any scenario of demonopolization, for several reasons. An incomplete network is not very valuable to mailers; e.g., a utility sending out bills wants wide geographic coverage. The advantage of complete network coverage is why carriers like UPS and FDX provide widespread service.

The assertion that mail deregulation will hurt rural areas is incorrect. PRC staff investigation has shown that there is no distinct geographic pattern to high and low cost service areas. Some urban routes are costly to serve because of traffic congestion. Many rural routes are cheap to serve because rural contract rates for carriers are lower than the wages paid to city carriers. (We need to explore the rural carrier method of compensation and work rules. It may be a better way to compensate carriers on other types of routes.) Moreover, the revenues brought in on routes vary according to complex demographic factors, such as income levels, not clearly associated with rural versus urban labels. In short, it would be costly and inefficient for mailers and carriers to segregate out unattractive routes. The free market will provide universal service. In fact, it might provide *more* service to, e.g., rural areas. For example, while there are

38,000 post offices, the retail pharmacy industry has about 55,000 retail establishments located in nooks and crannies throughout the U.S. To remove fears that there will be some instances of service voids, it is much less expensive to authorize a targeted subsidy program as has been done at the FCC for universal connectivity and at DOT for small community airline service. For these reasons I am not persuaded by the Transformation Plan discussion of reasons for retaining the monopoly. See Transformation Plan Appendix U-10, et seq.

GSEs may not be the answer. I do not especially favor a GSE approach unless it puts us well down the road towards privatization. What market failure justifies dependence on the GSE corporate form when the private sector parcel and expedited delivery markets in this country run fine without special governmental protections? Some believe that only a government-operated or sponsored institution should move the mail. In fact, much critical information moves by unregulated media. The government does not sponsor or control the Internet, where important financial transactions are increasingly occurring. Businesses entrust their most important financial documents to private courier services. The public trusts companies such as UPS and FedEx and the less-than-truckload trucking industry to move high-value packages. For purposes of security of mind, the “sealed against inspection” law can be made to apply to private companies. The idea that the U.S. Postal Service is the only trustworthy company is belied by USPS Inspector General statistics showing that postal workers are human; the latest OIG semiannual report indicates 300 employees

were arrested for mail theft, and it initiated 208 employee embezzlement investigations. There is no persuasive reason to permanently attach mail delivery to the federal government.

GSEs have many downsides. They operate under the public belief that there exists a moral (rather than legal) obligation of the government to support the corporation in event of financial instability. Because of this a GSE can issue debt obligations at a lower cost than a wholly private company. Further, partial government ownership can confer special benefits on the corporate entity, such as special treatment under the bankruptcy laws and exemption from various taxes and regulatory requirements. However, these blessings have distorting competitive effects. A postal GSE might create an uneven playing field that would unfairly disadvantage or deter would-be entrants into the postal market. Further, GSEs require frequent congressional involvement as markets change and as corporate charters become outdated. Changes may take years to accomplish once the initial statute is in place, witness the decades-long debates involving Fannie Mae and Freddie Mac. One thing we must avoid is creating a “reform” that takes three decades to reexamine again before we decide it does not work.

A postal GSE with partial governmental ownership carries the risk of significant legal liabilities for the U.S. Government. Does the Treasury Department want to face the issue of the government’s moral or legal obligation to compensate creditors of a postal corporation? By comparison, under current

law the government wisely has tried to distance itself financially from the USPS, e.g., USPS operations are not subsidized.

One also has to consider the future scope of operations permissible for the privatized corporation. To the extent these future ventures are riskier than providing postal service, the government would want to limit its guarantees to creditors. Constructing such liability limitations may be difficult to do in some circumstances and might lead to competitive inefficiencies. For example, a privatized corporation should be subject to the antitrust laws. One would not want, e.g., this new corporation colluding with competitors to fix prices. Yet if the government were part owner of the enterprise, would the enterprise (and its officers) be liable for treble damages or criminal sanctions under the antitrust laws? Would the Justice Department or the FTC have the incentive to prosecute?

However, if some form of GSE is recommended, it should be tailored to maximize market incentives, and the elimination of the monopoly should be preordained. This sunset provision will be an important motivator to get the GSE into a competition mindset. I am skeptical that even the best-equipped and well-intentioned regulatory agency will be able successfully to manage a hybrid system whereby half the mail is subject to controls and the other half is not. Accounting and cost allocation methods are arts, not sciences. The last draft postal legislation circulated by the House Committee on Government Reform in 2002 basically threw up its hands and said: "Let the regulator figure it out." This is not an acceptable approach. The difficulties that have occurred in constructing

an acceptable regulatory approach over a half man, half horse agency suggests that we need to severely limit the life of any GSE corporate structure as we move towards privatization and demonopolization.

To those who fear the jarring effects of sudden demonopolization, one can easily devise laws that gradually reduce the monopoly. In Europe mail weights are an element in the demonopolization schedule. Over time, more and more pieces will be subject to competition. Gradual demonopolization can also be done in operational segments, as has been done in telecommunications and power generation. The postal system has three components: retail acceptance, processing, and delivery. Retail acceptance and mail processing are clearly not natural monopolies.

I emphasize that even if one concludes delivery is a natural monopoly, which is open to doubt, that does not mean one should have a single delivery provider across the entire United States. One way to demonopolize delivery would be to give each local government the authority to decide who provides local delivery, in much the same way that local governments decide who gets to provide local garbage or cable service. Citizens of the local government could choose their preferred level of service; e.g., businesses might want more frequent service. (Under the current system Congress has decided we all want six-day service, which may be a costly and incorrect supposition.) Bidding by companies (including the USPS) for the rights to perform the specific services a local community wants should drive costs down and improve service.

Constructing a new regulatory policy will take time, but some reforms can be enacted that will ease the transition to competition and provide a better mail system in the short run. First, we must be patient while the PMG reduces the number of mail processing facilities. Reacting to individual constituent complaints, members of Congress sometimes pressure the USPS to keep as many facilities and jobs as possible in each district. USPS should be required to develop and implement a downsizing plan that is made public, but be given assurances of congressional non-intervention. If voluntary restraint fails, Congress could pass legislation to establish a commission similar to that used for closing military bases.

The Service's management bonus pay system should be overhauled, tied exclusively to the size of the yearly operating surplus. In the past the Service seemingly readjusted its myriad bonus criteria to benefit managers when it appeared the original performance objectives were not going to be met.

The Postal Service should be required to develop service standards for all mail classes, measure that performance, and make the data public. It should not be allowed to improve its bottom line by imposing additional costs on mailers through inferior service. To quote Alfred Kahn, "buyers can be exploited just as effectively by giving them poor or unsafe service as by charging them excessive prices." "Price really has no meaning except in terms of an assumed quality of service . . . [p]rice regulation alone is economically meaningless."

The USPS exemption from the truth-in-advertising laws embedded in the Federal Trade Commission Act should be removed as soon as possible.

Truthful information is a powerful source of marketplace competition. Truth-in-advertising accountability would require USPS management to be more responsive to the public's need for accurate information.

Congress should enable the Service to revamp its retail operations quickly by letting it sell stamps at a discount. I understand that the Service is reforming its operations over time. See Transformation Plan, p. 13 *et seq.* But if the Service can cut costs faster and provide more convenient service by selling stamps at discount (i.e., wholesale) prices to contract offices and private sector retailers it should be encouraged to do so. This may be a difficult political issue, at least in the short run. Ultimately, the nation will realize it needs fewer traditional post offices. And the social role of some post offices as well as historic postal buildings must be preserved. But if the Service is correct that many post offices are big money losers, then these excess system costs hurt all of us, and the poor disproportionately so.

This Commission also needs to examine whether the real estate management and acquisitions operations of the Postal Service should be privatized or contracted out so that cash from the increased value of long-held properties could be generated or lease revenues maximized. The long-term strategic value of the USPS retail network and its community support functions need a thorough analysis separate and apart from a search for short-term gains. The Commission could request such a report from the USPS and then make appropriate recommendations.

This Commission should also suggest that Congress make changes to the USPS pay system, which, unlike the federal government pay system, does not have locality pay adjustments. The postal pay system may have the unintended effect of discriminating against minorities. My own brief investigation showed that the cities with the highest minority populations in the U.S. tend also to be the cities with the highest costs of living. Because there is no postal locality pay adjustment, the postal wage dollar does not stretch as far for a worker in a high cost city like Washington, D.C.

Improvements to the ratemaking process under current law have been considered and should be encouraged. One essential legislative reform is for the Postal Rate Commission to have subpoena powers over the Postal Service so we can get better and timelier costing data. We are generally reliant on studies and data sets prepared by the Postal Service. Oftentimes we would rather see different slices of the data, or have them retrieve different data. We cannot order them to do so. For example, we have been saddled for years with an outdated, inaccurate street carrier cost system. The process of requesting updated or new data from USPS necessary to hear rate cases properly often adds considerably to the length of the hearing process, and to the expenses of the parties.

CONCLUSION

In closing, I would stress that change is necessary, but any proposed change should put us on the road to full competition in the postal industry.

Without market forces to spur efficiency, the industry will not survive as an effective communications option in the coming decades.