REBUTTAL COMMENTS
OF
UNITED PARCEL SERVICE

INTRODUCTION

United Parcel Service (UPS) appreciates this opportunity to respond to the comments submitted by other parties who, like UPS, have a strong interest in the important work being done by this Commission. In this rebuttal statement, UPS will primarily address (1) the implications of permitting the Postal Service to operate outside of its core mail monopoly, (2) the negative impacts inherent in granting the Postal Service – a government agency with a statutory monopoly – more flexibility in setting its prices, and (3) the assertion that pre-implementation ratemaking requires lengthy and expensive proceedings.

THE POSTAL SERVICE SHOULD FOCUS ON ITS CORE MAIL MONOPOLY.

Many parties have emphasized that the Postal Service should confine its activities to its "core" products. See Statements of ADVO, Inc. (p. 13), the American Postal Workers Union (pp. 20-21), the Association for Postal Commerce (p. 6), and Pitney Bowes Inc. (p. 17). Although the parties' views of what constitutes that "core" may differ, UPS strongly agrees that the Postal Service should have a clearly-stated, distinct mission. However, this mission should be the delivery of hard-copy information – not packages.

Originally established as a public service for the delivery of letter mail, the Postal Service now offers an expansive line of products and services. The wide array of services it offers has diverted the Postal Service's management and resources away from its central purpose.

To achieve financial viability, the Postal Service should do what it does best, and not divert its time, energy, and resources to services peripheral to its primary purpose. The Postal Service should be given clear direction on what its primary mission is, so that it can dedicate its resources to the efficient provision of those services. Until the Postal Service has a clear and certain statement of purpose, it will be unable to effectively or efficiently work toward delivering on that mission.

GIVING PRICING FLEXIBILITY TO THE POSTAL SERVICE WILL NOT CREATE INCENTIVES FOR COST CONTROL OR EFFICIENT OPERATION.

A number of parties have argued that the Postal Service should be given greater flexibility to set its own prices. These parties include Advo, Inc. (p. 10), the Direct Marketing Association (p. 6), the National Postal Mail Handlers Union (pp. 11-12), and the Saturation Mailers Coalition (p. 9). Among the ideas they propose are post-implementation rate review and the creation of two separate ratemaking procedures – one for the Postal Service's monopoly services and another, more flexible ratemaking procedure for its competitive services – instead of an integrated ratemaking approach.

UPS strongly disagrees with these arguments. Increased pricing flexibility will not ensure the efficient operation of the Postal Service or its viability. Not only would increased pricing flexibility be an ineffective response to the Postal Service's problems, but it would also create a serious risk of substantial harm to the majority of the Postal Service's customers as well as to its privately-owned competitors. Without effective pre-implementation rate regulation for all of the Postal Service's products, the subsidization and other dangers inherent in a hybrid monopolist/government-owned competitor will be left unchecked.

1. Pricing Flexibility Has Not Helped the Postal Service in Areas Where It Already Has Such Flexibility.

Calls for increased pricing flexibility ignore the fact that pricing flexibility has failed to achieve successful financial results in those areas where the Postal Service now has complete pricing flexibility and has exacerbated the subsidization of competitive products. The Postal Service is totally free from regulatory oversight when it sets its prices for its international services and for its "non-postal" products and services. Thus, these services have functioned as *de facto* pilot programs for the complete elimination of regulatory oversight. The results have not been a model of success.

The relative contribution to overhead (institutional costs) of the Postal Service's international services has been cut in half over the last 20 years. Even more revealing are the recent findings by the PRC and the General Accounting Office that certain highly competitive international package and express services were operated at a loss. Postal Rate Commission, 1998 Report to Congress on International Mail Volumes, p. 35; General Accounting Office, Report No. GAO/GGD-99-15, Development and Inventory of New Products (November 1998), p. 19. One of those services was eventually eliminated. This recent history does not support giving pricing flexibility to a government monopoly that also competes against privately-owned firms.

Similarly, pricing flexibility for "non-postal" ventures has hurt rather than helped mailers and the Postal Service. Using information from the General Accounting Office and the Postal Service itself, the PRC's Office of the Consumer Advocate has recently pointed out that "nearly all of the Postal Service's e-commerce and other commercial ventures *not reviewed by the [PRC]* have involved large expenditures with near-zero revenues." Letter from Consumer Action and the Office of the Consumer Advocate to the Postal Rate Commission, p. 2 (October 15, 2002), PRC Docket *2003 (emphasis added).

UPS also disagrees with the notion that increased "commercial flexibility," or some model similar to those adopted by certain other countries, is the solution for the Postal Service's financial problems. See, e.g., Statement of James I. Campbell, Jr. (p. 9). As Pitney Bowes' submission recognizes (at page 17), the revenue-enhancing initiatives of foreign posts have not yielded substantial benefits. Given the mixed results of these experiments, following their lead would be unwise.

Furthermore, UPS strongly disagrees with the view that pricing flexibility on competitive services is necessary to "sustain universal service." See, e.g. Statement of Parcel Shippers Association (p. 4). UPS agrees with the testimony presented to the Commission by the Postal Service's Chief Financial Officer that extraordinarily large increases in competitive volumes would be necessary to compensate for very small declines in monopoly products. This point is illustrated well by recognizing that Parcel Post – a competitive product – would need to increase to four times its current size to offset just a one percent decline in First-Class Mail volume. See 2001 USPS Cost and Revenue Analysis (PRC Version). These facts make clear that competitive services are not the solution to the Postal Service's financial challenges.

2. The Postal Service Needs to Control Its Costs.

Increased pricing flexibility addresses only the revenue side of the financial equation. Yet, as many parties have pointed out, the basic problem facing the Postal Service is its inability to accurately identify and control its costs. See, for example, Statements of the Alliance of Nonprofit Mailers (p. 4), American Business Media (p. 10), the National Association of Presort Mailers (p. 12), and the Institute for Research on the Economics of Taxation (pp. 2, 6). In order to improve its financial condition, it is critical that the Postal Service – like any enterprise – understand and control its costs.

Under the current regulatory scheme, the Postal Service incurs costs in the absence of appropriate accountability. The Postal Rate Commission does not have the authority to meaningfully reduce the Postal Service's

revenue requirement, or to command the Postal Service to lower its costs. Instead, the PRC's role is limited to finding a way for the Postal Service to generate the revenue that the Postal Service says it needs, regardless of the efficiency with which costs are incurred.

Weakening or eliminating regulatory oversight of the Postal Service's rates will not give the Postal Service incentives to, or the means to, control costs. Instead, it will do the opposite by making it easier for the Postal Service to set rates to cover whatever costs it incurs, rather than requiring it to examine whether all of those costs should be incurred.

Not only would providing the Postal Service with greater latitude to set its own prices be ineffective, but it would also create a risk of significant harm to the Postal Service's own customers as well as to its competitors. In the absence of strong cost control incentives (such as PRC authority to cut a Postal Service rate request), all mailers may end up paying higher rates.

3. Pre-Implementation Ratemaking Is Needed to Protect Monopoly Customers and Competition.

Some parties propose to replace the current pre-implementation ratemaking approach with post-implementation rate review (either automatically or on complaint), or to separate the pricing of monopoly services from that of competitive services in order to establish more price flexibility for competitive services. See, e.g., Statements of American Business Media (p. 14), the Association for Postal Commerce (pp. 3-4), the Direct Marketing Association (p. 6), the Greeting Card Association (p. 5, Attachment A), and the National Association of Postmasters of the United States (pp. 5-6). That would result in an even more ineffective system, which would have a seriously negative effect on the vast majority of the Postal Service's customers and its competitors.

Post-implementation rate review of any sort would be too little, too late. It would permit excessive monopoly rates and below-cost competitive rates to be in effect until overturned by the reviewing agency, which could be a long time. Effective remediation would be nearly impossible. The burden to come up with appropriate rates would shift from the Postal Service, which has sole control over the necessary data, to customers and competitors who do not have access to that information. To make matters worse, the oversight body in a post-implementation review setting loses important leverage to demand timely production of financial and accounting information because the regulated entity's chosen rates are already in effect. As a result, the public will be denied

meaningful participation in the ratemaking process. Moreover, improper rates that are already in effect may be approved, except in the more egregious cases, simply to avoid the disruptions involved in changing them.

Likewise, any suggestion that the rates for competitive services can be regulated differently from the rates for monopoly services ignores how the Postal Service operates. The Postal Service uses many of the same resources for both its competitive and its non-competitive services. (See response of Postmaster General Potter to question by Commissioner Seabrook at the January 8, 2003 hearing.) It is impossible to consider the costs and the proper rates for the Postal Service's non-competitive services without at the same time considering the costs and the rates for its competitive services. Given the time and resources that the public, the governing agency, and the Postal Service commit to the ratemaking process, it would be redundant and wasteful to divide one cohesive process into two separate ratemaking regimes that would otherwise consider many of the same issues concurrently.

Weakening regulation of competitive rates is risky. Contrary to a common misconception, the market does not automatically ensure proper prices for competitive products in the presence of a monopoly subsidy. A competitive market may guard against prices that are too high, but it does not insure against prices that are too low because of a subsidy from a government-granted monopoly.

THE PRESENT RATEMAKING SYSTEM SHOULD BE IMPROVED.

Given the Postal Service's structure, regulation of its rates should not be weakened – the benefits of a government-granted monopoly come with obligations. However, UPS believes that the current system of postal ratemaking can be, and should be, improved and streamlined.

1. The Postal Rate Commission Must Be Able to Prevent Competitive Product Subsidies.

The Postal Service engages in subsidization when its competitive services are priced below what they would otherwise be if it were not for its monopoly network advantage and its status as a government agency. The Postal Service's enormous infrastructure, given to it by the federal government, was created to provide monopoly letter delivery services to every residence and business in the United States. It uses that infrastructure, financed originally and still largely by monopoly revenues, to provide services that compete with private companies. Any business faced with a government-sponsored competitor which charges a disproportionate share of its large

infrastructure costs to monopoly services and a relatively minimal share of those costs to competitive products can rightfully claim that its government competitor is improperly subsidizing the competitive products.

The difficult task of properly allocating costs between monopoly services and competitive services should not be left to the party with an incentive to allocate the costs incorrectly. Rather, the determination of how much of the Postal Service's costs each of its services should bear is a job for an expert regulatory body that has no personal stake in the outcome and that will be able to protect all parties affected by the allocations. The answer to the question of why it has proven so difficult to correctly allocate postal costs is that the Postal Service has little incentive to do so, and the PRC does not have adequate authority to do so.

Even with incentives for cost control, the Postal Service's unique status as a government-controlled competitor necessitates strong and independent pre-implementation pricing oversight. As a federal government entity, the Postal Service enjoys broad and significant benefits, including exemptions from state and local taxing, licensing, and other regulatory requirements, which should be accounted for when setting its rates.

A strong and independent body must exist to protect customers from the improper exercise of monopoly power. It must also insure a level playing field to protect competitors from the unfair leveraging of the Postal Service's monopoly-created infrastructure advantages.

2. Pre-Implementation Ratemaking Can Be Streamlined.

Many parties have expressed a concern that pre-implementation oversight of the Postal Service's rates results in lengthy delays and a quagmire of regulatory procedure. See, e.g., Statements of the National Association of Postmasters of the United States (p. 5), Pitney Bowes Inc. (p. 11), and Richard J. Strasser, Jr., Chief Financial Office and Executive Vice President, U.S. Postal Service (p. 5-7). However, along with a number of other parties who have substantial experience with the current procedure, UPS believes that the length, complexity, and expense of ratemaking proceedings under the current statute are not a necessary corollary of effective regulation. See, e.g., Statements of American Business Media (p. 10) and the Newspaper Association of America (p. 22). With a stronger PRC and a number of other changes from the status quo, pre-implementation ratemaking can be streamlined while at the same time made more effective.

For example, when the Postal Service files a request for new rates, it often proposes new or substantially modified costing approaches. Resolving those costing issues is complex and time-consuming. Examining new or modified costing methods can and should take place separately from rate change proceedings. This would allow the

parties and the PRC adequate time to examine new costing approaches prior to the filing of a rate change request. The PRC could then use only pre-approved costing methods during a rate case, thereby expediting the case.

Rate cases could also be expedited if the PRC were able to demand more, and improved, data from the Postal Service – in other words, if it could command greater "transparency." Much of the parties' time and expense during a ratemaking proceeding are spent seeking information from the Postal Service. See comments of Mary Rouvelas, Alliance of Nonprofit Mailers, on the causes of the lengthy rate case process (bottom of p. 1 to top of p. 2). Regular reporting on a periodic basis (even between cases) of detailed, product-specific cost information that the Postal Service undoubtedly needs to manage its operations would dramatically reduce the time and expense of rate cases. Yet, without the ability to enforce its requests for information, a weakened PRC has often faced stiff resistance from the Postal Service when it tries to improve the quality, timeliness and frequency of the Postal Service's data reporting. See, generally, Initial Comments of the United States Postal Service, February 10, 2003, PRC Docket RM2003-3.

Pre-implementation ratemaking would be quicker and more effective under a strengthened PRC. The PRC should be made a full-fledged regulatory agency, with power to impose cost control incentives and enforce service quality commitments, rather than simply assisting the Postal Service in generating more revenue by "recommending" appropriate rates. Given the present system's lack of incentives to control costs, the PRC should have the ability to create such incentives, or the cost control problem will remain unsolved.

CONCLUSION

UPS urges the Commission not to forget the Postal Service's unique position as both a provider of monopoly services and a government-run competitor, and the effect of that unique status upon consumers and private enterprise. As long as the Postal Service has a monopoly over its largest source of revenue (monopoly services account for 85 percent of its total revenue) and also competes in other markets, it will inevitably have a strong temptation to raise prices as much as possible for customers who have no other option, and to lower prices as much as possible for competitive services in order to capture more competitive volume. This will harm Postal Service customers and competitors, and – in the end – this increased competitive volume will not solve the Postal Service's financial challenges.

UPS believes that "[t]he Postal Service is – first, last and always – a public service." House Report No. 91-1104, 91st Congress, 2d Session, p. 19. It should refocus on providing fundamental services to the public – in

particular, the delivery of hard-copy information – rather than on competing as a business in the markets that are well-served by private enterprise. As UPS Chairman and CEO Mike Eskew stated to the Commission, the public's need for express and package delivery is well-served by private sector competitors. No voids in service exist that necessitate government intervention in the express and package delivery market.

The viability of the Postal Service does not depend on weakened regulation. Rather, the Postal Service's viability depends on ensuring that the Postal Service focuses on its core mission and services instead of on marginal services where it faces competition, and on creating a framework that enables the Postal Service to accurately identify and control costs. A strengthened PRC with the tools to prevent the subsidization of competitive products is crucial in assuring that the Postal Service remains true to its mission of serving the public.