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Report to the Chairman, Subcommittee on the Postal Service, Committee on Government Reform and Oversight House of Representatives

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U.S. POSTAL SERVICE

Postal Ratemaking In Need of Change

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The Honorable John M. McHugh
Chairman, Subcommittee on the Postal Service
Committee on Government Reform and Oversight
House of Representatives

Dear Mr. Chairman:

This report responds to your March 7, 1995, inquiry about matters for congressional consideration contained in our March 1992 report to Congress on postal pricing.[1] You asked (1) whether changes in policies concerning volume discounting and demand pricing should still be considered by Congress, (2) what are the issues surrounding the current ratemaking process, and (3) what proposals for modifying the postal ratemaking process and other changes merit further consideration by Congress. The Postal Service's continued viability as a full-service provider in the current environment depends on several factors, including controlling costs and improving the quality of service. In this report, we focus on ratemaking issues.

Background

Under the Postal Reorganization Act of 1970 (the 1970 Act), the Postal Service is an independent establishment in the executive branch that began operations on July 1, 1971. The Postmaster General, Deputy Postmaster General, and the nine presidentially appointed members of the Postal Board of Governors direct the operations of the Postal Service. The 1970 Act set a number of goals, objectives, and restraints for the Postal Service. The Postal Service is to operate in a businesslike manner and is to break even in the long term. Unlike its competitors who can select the markets they serve, the Postal Service by statute must provide universal service to all urban, suburban, and rural customers at uniform and reasonable rates.

To regulate the Postal Service's adherence to ratemaking standards and to ensure that it does not take advantage of its monopoly—granted through the Private Express Statutes[2]—on the delivery of letter mail, the 1970 Act established the Postal Rate Commission as an independent establishment

[1] U.S. Postal Service: Pricing Postal Services in a Competitive Environment (GAO/GGD-92-49, Mar. 25, 1992).

[2] The Private Express Statutes (18 U.S.C. 1693-1699 and 39 U.S.C. 601-606) are a set of federal laws enacted originally in 1792 to restrict private carriage of letters. Congress enacted these laws primarily to guarantee a healthy postal system that could afford to deliver letters between any two locations, however remote.

of the executive branch. The 1970 Act requires the Postal Service to file with the Commission a request for changes in rates for all services offered. As part of its request, the Postal Service provides detailed information and data explaining revenue requirements, mail-volume estimates, costing, pricing, and rate design. The Commission must hold public hearings and allow interested parties, including Postal Service competitors, the opportunity to make their views on proposed rate changes known. The Commission is required to provide the Postal Service's governors with its recommended decision on new rates within 10 months of the filing. In making its decision, the Commission is required to take into account the nine criteria (see app.I) specified in the 1970 Act.

The ratemaking criteria set forth in the 1970 Act were established during a period when the Postal Service had less competition than it does now. The Postal Service now operates in a different environment because of increasing competition from private companies and advances in electronic communications. In 1992, we reported that Congress should reexamine the nine criteria set forth in the 1970 Act and consider amending them to state, among other things, that in allocating institutional costs, demand factors are to be given a weight that takes into account the need to maintain the long-term viability of the Postal Service as a nationwide full-service provider of postal services, and to determine whether these criteria are still valid in light of changing marketplace realities.

Since the late 1970s, the Postal Service and the Commission have disagreed over the extent to which the ratemaking criteria allow the use of demand factors to allocate the Postal Service's overhead burden among the various mail classes. The Postal Service believes that demand factors should play a major role in overhead cost allocation in determining prices for various mail classes to recognize market realities, whereas the Commission has in the past placed less weight on demand factors in its pricing decisions than the Postal Service has. This report focuses on this issue as well as volume discounting.

Results in Brief

Legislative changes to the 1970 Act's ratemaking provisions may be necessary to recognize market realities which have contributed to the reasons why the Postal Service has not been an effective competitor in some markets. These reasons include such factors as price and regulatory constraints. In our 1992 report, we said that Congress should reexamine the 1970 Act to (1) determine if volume discounting by the Postal Service would be considered a discriminatory pricing policy and (2) clarify the extent that demand pricing should be considered in postal ratemaking.

Recently, the Postal Service sent the Commission (1) a petition to initiate rulemaking that would give it more flexibility in pricing postal products[3] and (2) a proposal to establish a market-based mail classification schedule.[4] Although we still believe that our 1992 matters for congressional consideration have merit, their consideration by Congress might be more useful after the outcome of these Postal Service initiatives is known.

For the reasons discussed in our 1992 report, we believe that if the Postal Service is to be more competitive, it needs more flexibility in setting postal rates and that postal rates should be based to a greater extent on economic principles that consider volume discounting and demand pricing. This is not meant to exclude other factors addressed in the ratemaking criteria prescribed in the 1970 Act. These pricing mechanisms, which recognize market factors, could help minimize mail volume losses due to competitive forces and help keep rates lower for most mail classes and subclasses over the long term.

At present, the Postal Service and the Commission disagree, as they have in the past, on the relative weight to be given to market factors versus other elements, such as principles of fairness and equity, in setting rates. Resolving this situation may require that Congress clarify the ratemaking criteria established in the 1970 Act.

Postal ratemaking is a complex process that usually takes 10 months; however, this period does not include the time the Postal Service spends preparing a rate case, nor the time it takes for an appeal when the Board of Governors and the Commission do not agree. Various study groups believe that the current process takes too long for the Postal Service to respond to today's rapidly changing market conditions.

Over the 25-year period since the 1970 Act, many studies have proposed changes to the postal ratemaking process. We believe that proposals by the Institute of Public Administration and the Joint Task Force on Postal Ratemaking have merit and deserve consideration by Congress. The Institute of Public Administration examined the process by which prices

[3]On April 10, 1995, the Postal Service petitioned the Commission to, among other things, give the Postal Service the authority to offer volume-based rates.

[4]Mail Classification Schedule, 1995, Classification Reform I, Docket No. MC95-1.

are set for mail services and assessed the process in terms of timeliness, flexibility, simplicity, and fairness. In its 1991 report to the Board of Governors, the Institute concluded that the ratemaking process had adversely affected the Postal Service's ability to serve the public and compete in a changing, competitive environment.[5] The Institute recommended that a joint task force be set up to draft a comprehensive revision of rules governing ratemaking and classification. The Institute also proposed a number of legislative changes. In response, the Postal Service and the Commission established a joint task force to examine ratemaking problems and make proposals for new procedures. The task force made several recommendations that seem to have merit.[6] They include developing accelerated procedures for market testing new products, establishing rate bands for competitive products, and allowing a form of volume-based rates for high-volume shippers.

In addition to ratemaking reforms discussed previously, other provisions of the 1970 Act may require changes if the Postal Service is to be more competitive. For example, as discussed in our automation and labor-management reports,[7] Congress may want to reexamine those aspects of the 1970 Act that affect the Postal Service's ability to control labor costs and resolve workforce issues. Without progress in these and other areas, such as avoiding the frequent use of binding arbitration to settle labor disputes, it will be difficult for the Postal Service to be competitive in the marketplace, regardless of ratemaking changes.

Scope and Methodology

In preparing this report, we reviewed the Commission's rate decision for 1994 (Docket No. R94-1), the Postal Service's testimony supporting the 1994 rate case, expert testimony given on demand pricing, technical papers on postal pricing policies, and our past work. We also discussed the 1994 rate case with Postal Service and Commission officials. In addition, we reviewed reports that recommended reforms to the ratemaking process, in particular, reports by the Institute of Public Administration and the Joint Task Force on Postal Ratemaking.

[5] The Ratemaking Process for the U.S. Postal Service, report of the Institute of Public Administration to the Board of Governors of the U.S. Postal Service (New York: Institute of Public Administration, Oct. 8, 1991).

[6] Postal Ratemaking in a Time of Change, a report by the Joint Task Force on Postal Ratemaking submitted to the Board of Governors of the United States Postal Service and the Postal Rate Commission, June 1, 1992.

[7] Postal Service: Automation Is Taking Longer and Producing Less Than Expected (GAO/GGD-95-89BR, Feb. 22, 1995), and U.S. Postal Service: Labor-Management Problems Persist on the Workroom Floor (GAO/GGD-94-201A & 201B, Sept. 29, 1994).

We received written comments on a draft of this report from the Postal Service and the Postal Rate Commission. We discuss these comments at the end of this report. Copies of the comments are located in appendixes II and III.

We did our work in Washington, D.C., between March and May 1995 in accordance with generally accepted government auditing standards.

Our 1992 Analysis

In our March 1992 report, we said that to better compete in the current market, the Postal Service needs more flexibility in setting postal rates and that these rates should be based to a greater extent on economic principles. Therefore, we suggested that Congress should reexamine the 1970 Act to (1) determine if volume discounting by the Postal Service would be considered a discriminatory pricing policy and (2) clarify the extent that demand pricing should be considered in postal ratemaking. These pricing mechanisms could help minimize mail volume losses due to competitive forces and help keep rates lower for most mail classes over the long run. The reasons underlying our position follow.

Volume Discounting

Three mail categories are subject to significant direct competition where Postal Service competitors provide discounts to large volume customers: parcel post, Express Mail, and Priority Mail. These three categories accounted for $4.7 billion or 10 percent of total Postal Service 1994 revenues. As we reported in March 1992, the Postal Service lost major market share in the multi-billion dollar parcel post and Express Mail markets.[8] Although other factors contributed, such as the operating costs faced by the Postal Service and quality of service, a key element in this loss was that the Postal Service could not offer competitive prices to large users.

The Postal Service's Priority Mail (second-day) service is its fastest growing service and has a mix of statutorily protected and unprotected material. According to the Postal Service's Origin-Destination Information System database, about 53 percent of Priority-Mail volume consists of small parcels and packages not subject to the Private Express Statutes or urgent letter regulation. This market is being pursued by competitors of

[8]The Postal Service's fourth-class parcel mail services do not include letters, as defined by Postal Service regulation, and thus are not protected by the Private Express Statutes. In 1979, the Postal Service issued a regulation (39 C.F.R. 320.6) that suspended operation of the Private Express Statutes for private carriage of "extremely urgent" letters, and overnight delivery of such letter mail has been opened to competition.

the Postal Service through aggressive pricing strategies and service offerings.[9]

In our March 1992 report, we said that if the Postal Service is to be more competitive, it will need greater pricing flexibility in markets exposed to direct and growing competition, including its second-day market, as well as its overnight and parcel post markets. The Postal Service lacks authority to revise rates quickly or grant volume discounts to users of its competitive services. It has proposed volume discounts for Express Mail and certain international services.[10] The Commission did not accept the Express Mail proposals. However, after a federal district court ruled that the Postal Service's proposed volume discounts for international mail service unreasonably discriminated among mail users and could not be implemented, the United States Court of Appeals for the Third Circuit reversed the District Court's ruling and upheld the authority of the Postal Service to implement volume discounts.

Demand Pricing

The Postal Service is a multiproduct, regulated enterprise subject to varying degrees of competition in its product lines. Since the late 1970s, there has been a basic disagreement between the Commission and the Postal Service on the extent that the principles of economically efficient pricing or Ramsey pricing can be applied to postal ratemaking. Ramsey pricing has been used in varying degrees as a basis for ratesetting in regulated industries, and its advantages have been analyzed at length in the economic literature. Under Ramsey pricing, an agency that regulates a natural monopoly would set prices so that in each market segment, the percentage markup would be inversely proportional to the elasticity of demand[11] in that segment. For example, available evidence from Postal Service econometric models shows that First-Class Mail is more inelastic than third-class mail. In this situation, use of Ramsey pricing or the inverse elasticity rule would result in allocating a higher-than-average percentage of the institutional costs to First-Class Mail and a lower-than-average percentage to third-class mail.

[9]See our report U.S. Postal Service: Priority Mail at Risk to Competition If Double Postage Rule Is Suspended (GAO/GGD-92-68, May 7, 1992).

[10]The Postal Service proposed volume discounts for Express Mail in its R87-1 and R90-1 rate cases. The Postal Service's proposed volume discounts for its International Customized Mail Service were contested before the United States District Court for the District of Delaware. The ruling of the Federal District Court against the Postal Service was reversed by the United States Court of Appeals for the Third Circuit; UPS Worldwide Forwarding, Inc. v. United States Postal Service, 853 F. Supp. 800 (D. Del. 1994), rev'd, No. 94-7423 (3rd Cir. Sep. 15, 1995).

[11]Elasticity of demand measures the sensitivity of customer demand to historic changes in prices. Elasticities are estimated using econometric models.

It should be noted that Postal Service estimates included with R94-1 show that demand for 15 selected mail categories is inelastic. In one category, Express Mail, demand is elastic. Under Ramsey pricing, the markups depend on relative elasticities, not whether demand for a particular postal service is elastic or inelastic. As illustrated in R94-1, on the basis of Postal Service elasticity estimates, a 10-percent increase in the First-Class letter rate would result in about a 2-percent loss in volume.

Although the Postal Service and the Commission both agree that market factors should play a role in ratemaking, our March 1992 report described the different views and strategies they have in applying these factors in the ratemaking process. Since our report, another omnibus ratemaking proceeding has been completed (Docket No. R94-1). In the 1994 rate case, the Postal Service's strategy was to keep the rate change process relatively simple and provide enough revenue until it could propose a major rate reclassification. It requested a 10.3-percent increase for most major subclasses, which the Postal Service said was less than the economywide rate of inflation since its March 1990 filing. The Commission did not accept the proposed uniform rate increase, stating that the resulting rates for some classes would not be in accordance with the 1970 Act's requirement that the Commission recommend rates that are fair and equitable.

As in previous rate cases, one disagreement in R94-1 centered on the Postal Service's proposed allocation of a large portion of the $19.7 billion in total institutional costs to First-Class letters and third-class bulk mail, which together account for 83 percent of postal mail volume and 78 percent of postal mail revenue.[12] These allocations are made as "markups" to the costs that can be attributed to each mail class. The Postal Service proposed to mark up by 81.5 percent the costs attributed to First-Class letters. According to the Commission, this markup would result in First-Class Mail absorbing 77 percent of total institutional costs—an increase of 5 percentage points over the contribution approved in the 1990 rate case. The Commission considered this an excessive burden for First-Class mailers, considering that the costs attributed to First-Class had declined from 60 percent to 58 percent since the 1990 case.

In support of its uniform rate proposal, the Postal Service said that the cost allocations proposed in R94-1 for First-Class letters and third-class

[12]A similar disagreement between the Postal Service and the Commission concerning the role of economic variables has arisen in the last two rate cases over the proper method for attributing city delivery carrier access and coverage related load costs totaling about $3 billion. In addition, the Postal Service and Commission disagreed on the need for and quality of certain data for setting rates in the 1994 case.

bulk mail were more in accord with Ramsey pricing principles than were the allocations in recent Commission-recommended decisions. In addition, the Postal Service said that its emphasis on demand factors is consistent with the criteria in 39 U.S.C. 3622(b), in particular, section 3622(b)(2) dealing with the value of the mail service to both the sender and the recipient.

The Commission believed that the Postal Service's proposed allocation of institutional costs to these two major mail categories would be a significant departure from previous rate-case decisions. The Commission's stated objective in previous rate cases was to have First-Class markups slightly above the systemwide average and third-class markups slightly below the systemwide average. The Commission allows a lower markup for third-class bulk regular mail to reflect its "higher elasticity of demand, the potential for volume diversion to alternative delivery, and the need to set rates which are responsive to the market," as well as to recognize "the low intrinsic value of its service standards and service performance."

The Commission calculated rate changes necessary to return to the relative markup relationships that were recommended in the 1990 rate case. On the basis of this analysis, the Commission found that the third-class bulk regular rate would require a 17-percent increase rather than the uniform 10.3-percent increase proposed by the Postal Service. In its recommendation to the Board of Governors, however, the Commission limited the third-class bulk regular rate increase to 14 percent. The Commission tempered the rate increase to reflect its concern with the impact a larger rate increase would have on users of this service. As finally recommended, the First-Class letter markup was 131 percent of the systemwide average, and the third-class bulk mail markup was 90 percent of the systemwide average. While the Commission accepted the Postal Service's proposed 32-cent rate for the First-Class stamp, it recommended a smaller increase than the Postal Service's proposed rate for postcards and no increase in the extra ounce rate for letters weighing more than 1 ounce.

The Postal Service and the Commission also disagreed on the resulting rate increases among the competitive mail categories. For example, the Commission recommended a lower-average rate increase (4.8 percent) for Priority Mail, overall, than the uniform rate increase (approximately 10.3 percent) proposed by the Postal Service, because it believed the rate proposed would place an unfair institutional cost burden on this mail component.[13] Similarly, the Commission recommended a lower rate increase for Express Mail (8.0 percent compared to 10.2 percent) because it had the highest elasticity of any mail class. While it recommended lower rates in two competitive categories, the Commission recommended a higher rate increase (18 percent) for fourth-class parcel post, another highly competitive market, instead of the Postal Service's proposed 13 percent. The Commission believed that this small mail component should make a higher contribution to institutional costs than that proposed by the Postal Service.

As we noted in our March 1992 report, the Postal Service and the Commission do not agree on the extent to which demand factors can be used to price postal products. There appear to be two principal sources of disagreement. First, section 3622 (b) of the 1970 Act specifies nine criteria to be used in setting postal rates. (See app. I.) These criteria set a number of potentially conflicting objectives, and the Postal Service and the Commission disagree on the relative emphasis to be placed on each of them.

Second, the implementation of a pricing scheme that includes demand factors crucially depends on the availability and quality of data on economic variables and on the econometric methodology that is used to analyze the data and derive estimates of relative demand elasticities.[14] The Commission has generally been more pessimistic than the Postal Service about whether the current state of the art is sufficiently advanced to permit heavy reliance on demand-based pricing.

With regard to these disagreements, we made the following observations in our 1992 report, which we believe are still germane. First, we recognize that existing law requires the Commission to balance multiple objectives in setting the rate structure. For that reason, we do not advocate the application of Ramsey pricing principles to the exclusion of other considerations. However, the pursuit of diverse objectives comes at a price in terms of loss of consumer welfare, as well as possible erosion of the Postal Service's competitive position in the long run. Further, there is every reason to believe that changes in the economy that have taken place since 1970 have increased the potential cost to the Postal Service and the economy of pursuing diverse objectives. Resolving this situation may

[13]While the Commission recommended an average rate increase of 4.8 percent, the recommended rate increases for heavier-weight Priority Mail (6 to 70 pounds) ranged from 12 percent to 34 percent in zones 1 through 5.

[14]See GAO/GGD-92-49, appendixes II and III.

require that Congress clarify the ratemaking criteria set forth in the 1970 Act.

Second, we are aware of ongoing disagreements among econometricians who have studied technical issues related to demand-based pricing. However, we continue to believe that decisions should be made on the basis of the best information available, and that policymakers should not wait for such controversies to subside before taking action.

The Current Postal Ratemaking Process

Postal ratemaking is a complex process that usually takes 10 months—the statutory deadline established by Congress in 1976. This period does not include the time the Postal Service spends preparing a rate case, nor the time it takes for an appeal when the Board of Governors and the Commission do not agree. In the last rate case (R94-1), the Commission issued its recommended decision in less than 9 months. While we do not know how long the process should take, various study groups believe that the current process takes too long for the Postal Service to respond to today's rapidly changing market conditions.

The ratemaking process begins when the Postal Service files a formal request with the Commission for rate changes. The Postal Service provides detailed information and data explaining (1) revenue requirements, (2) mail volume estimates, (3) costing, (4) pricing, and (5) rate design. As required by the 1970 Act, the Commission holds public hearings and allows interested parties the opportunity to make their views known. A typical rate case can involve up to 100 parties, 150 witnesses, and several rounds of hearings lasting many days or weeks. In addition to the Postal Service and an officer of the Commission representing the interests of the general public, the parties and witnesses represent an array of interest groups, including (1) commercial mailers, (2) publishers and publishers' associations, (3) Postal Service competitors, and (4) Postal Service unions.

The most important and time-consuming parts of the proceedings center on the Postal Service data explaining the attribution and assignment of costs to specific services or classes of mail and the rate design based on those data. As long as the core letter mail business—represented largely by First-Class and third-class mail and accounting for about 80 percent of revenues—is protected by the Private Express Statutes, some type of regulatory oversight will be necessary. The President's Commission on

Postal Reorganization ("Kappel Commission") whose 1968 report[15] persuaded Congress to pass the 1970 Act said that "were we to recommend a privately-owned Post Office," which it did not, "rate regulation by an independent Federal commission would be a necessary and appropriate corollary." Instead, the Kappel Commission recommended that Congress establish an independent government-owned postal corporation. The Kappel Commission said that it saw no advantages to, and had serious problems in, proposing the regulation of a government corporation by another government body.

Proposals for Modifying the Postal Ratemaking Process

Over the 25-year period since the 1970 Act, many studies, including four by us,[16] have proposed changes to the postal ratemaking process. The remaining section of this report focuses on proposals for modifying the postal ratemaking process contained in two recent and important studies that were completed in fiscal year 1992. These studies, like our pricing report, focused on ratemaking changes to reflect the competitive environment in which the Postal Service operates. The findings and recommendations in earlier studies are generally revisited in these more recent reports.[17]

Institute of Public Administration

Because of the contention between Postal Service management and the Commission over the 1990 rate case, the Board of Governors contracted with the Institute of Public Administration[18] in May 1991 to study the ratemaking process. The study examined the process by which prices are set for mail services and assessed the process in terms of timeliness, flexibility, simplicity, and fairness. The Institute's report to the Board of Governors in October 1991 concluded that the ratemaking process had adversely affected the Postal Service's ability to serve the public and compete in a changing competitive environment.

[15]Toward Postal Excellence: The Report of the President's Commission on Postal Organization, President's Commission on Postal Organization (Washington, D.C.: Government Printing Office, June 1968). Most of the commissioners were chief executive officers of major corporations.

[16]In addition to our 1992 pricing report, see The Role of the Postal Rate Commission Should Be Clarified (GAO/GGD-77-20, Apr. 1977), A Case Study of Why Some Postal Rate Commission Decisions Took As Long As They Did (GAO/GGD-81-96, Sept. 1981), and Opportunities to Improve the Postal Ratemaking Process (GAO/GGD-84-10, Apr. 1984).

[17]A chronology, listing, and summary of the other studies are discussed in Part IV of the report issued by the Institute of Public Administration. (See footnote 5.)

[18]The Institute of Public Administration is a private, nonprofit organization whose staff members include specialists in public and business administration, finance, political science, and economics.

The study found that the process had become too cumbersome, rigid, and narrow to best serve the overall financial interests of the Postal Service and its customers. The Institute made a number of recommendations that would, among other things, allow the Postal Service more flexibility to compete, as well as an increased ability to protect the system from financial loss. It did not make any specific recommendations for changing the rate criteria. However, it stated that (1) "the full range of factors listed in the Postal Reorganization Act should be used in redefining rate criteria" and (2) the Commission's use of "historical average" markups to guide ratemaking "is an inappropriate criterion, and not on the list in the Act." This latter point was consistent with our view in the 1992 report on pricing postal services in a competitive environment.[19]

The Institute recommended that the Board of Governors and the Commission establish a joint task force to draft a comprehensive revision of rules governing ratemaking and classification and propose a strategy for reform of the process. Among many other ideas, it also offered several that we believe merit further consideration: (1) base an omnibus rate case on a 4-year financial plan, rather than on a 1-year test period; (2) have the Postal Service and the Commission agree on categories of information to be submitted with the plan, which should become regular products of budgeting and information systems, thus reducing the need for special statistical studies for ratemaking; and (3) permit the Postal Service to compete on "level playing fields" in its competitive markets, while also constantly improving its existing core services by controlling costs and improving efficiency.

The Institute also proposed legislative changes that we believe merit consideration as follows:

- require the Commission to determine which segments of Postal Service proposals are competitive and use expedited review processes for rate changes on these segments,
- give the Postal Service experimental authority to market-test new products and service enhancements without being subjected to the standard rate and classification procedures of the Commission,
- change the requirement that unanimous consent of the Board of Governors is needed to reject or modify a Commission-recommended decision to a two-thirds majority requirement, and
- eliminate the second round of rate-case reconsideration.

[19]As part of that review, we analyzed the Commission's rate decisions from 1971 to 1990.

Joint Task Force on Postal Ratemaking

In response to the Institute's report, the Postal Service and the Commission established a joint task force to examine the problems of ratemaking and to provide proposals for new procedures that would eliminate some of the structural rigidities. The Commission and the Governors each appointed four members to the task force. The eight-member task force started its work in January 1992 and issued its unanimous report on June 1, 1992. The task force found "a need for more flexibility in pricing by the Postal Service, a need for greater predictability of prices, and a continuing need for greater accountability in postal financial performance." The task force proposed a number of recommendations, none of which has been implemented. Based on past work on postal ratemaking, our observations on some of the key recommendations follow.

First, the task force recommended that postal ratemaking be based on a 4-year, 2-step rate cycle. Under the 4-year cycle, the Commission would recommend rates for the first 2 years of the cycle and project but not recommend rates for the remaining 2 years. A midcycle case proceeding would be held to validate or adjust the earlier proposed rates, but the scope would be limited in that the Commission would not revisit cost attribution methods, volume estimating methods, and pricing policies or other factors affecting assignment of institutional costs. According to the task force, the proposed 4-year process would (1) provide better rate matching to marketplace realities, (2) provide more predictable rate increases in smaller increments, (3) reduce the costs of the ratemaking process, and (4) improve accountability in financial performance. Looking at the Postal Service's financial and operating needs over a 4-year period, rather than a single year as is currently practiced, was similar to the proposal suggested by the Institute.

Among the issues that need further study would be (1) whether the Postal Service can accurately project revenues and expenses for 4 years; (2) how the specific proposal would be implemented; (3) what rules and procedures would need to be changed in the two-stage process; and (4) what would be the views of the Postal Service, mailers, and other interested parties to the proposed rate-case cycle.

To address these issues, the Commission issued a Notice of Proposed Rulemaking in August 1992 containing proposed rules on implementing the 2-phase, 4-year rate cycle for omnibus rate proceedings.[20] In its October 13, 1992, comments, the Postal Service disagreed with the

[20]See Federal Register, Vol. 57, pp. 39160-73, Aug. 28, 1992.

proposed rules believing there were more disadvantages than advantages. Basically, the Postal Service wanted a more flexible approach to general rate proceedings and did not want to be locked into a rigid 2-phase, 4-year rate cycle. While the Postal Service did not support the proposed general rate cycle, it encouraged the Commission to formulate procedures to address other recommendations made by the joint task force (see below), which the Postal Service believed would be more responsive to its needs in a competitive environment.

Second, the task force suggested changes in how rates are set for mail that directly competes with products offered by the private sector. The three service areas it identified as competitive classes were Express Mail, parcel post, and heavy-weight Priority Mail. The task force recommended that the Commission adopt a "rate band" approach to introduce more flexibility in setting rates for these products. Under this proposal, upper and lower bands for each rate element within the rate category's rate structure would be recommended by the Commission. Within these bands, the Postal Service would be free to select specific prices after giving appropriate notice to its customers. In establishing the rate bands, the Postal Service and the Commission would ensure that the lower rate band covered attributed costs and made a minimum acceptable contribution to institutional costs to "protect against the possibility of cross-subsidy" from another mail class.

Third, a proposal that would recognize market pricing strategies dealt with developing a system of "declining block rates" to create incentives to postal customers to increase usage. This recommendation, if adopted, would allow the Postal Service to offer discounts to large-volume users in its competitive markets. When the Postal Service proposed discounting schemes in past rate cases, a major issue was rate discrimination, as discussed in our March 1992 report.

In addition, the task force made a series of recommendations to help the Postal Service experiment with new product lines and changes in service, which currently are subject to lengthy reviews by the Commission and the public. These recommendations include accelerated review procedures for marketing new products and services and multi-year cost recovery for new service introductions.

As we previously mentioned, the Postal Service filed a petition with the Commission on April 10, 1995, to obtain more flexibility in ratemaking. In this petition, the Postal Service asked the Commission to consider the recommendations of the task force that the Postal Service had not rejected in October 1992. In addition, the Postal Service has filed a proposal with the Commission to establish a market-based classification schedule that, among other things, restructures First-Class and bulk regular third-class mail.

Although we still believe that Congress should consider changes in policies concerning volume discounting and demand pricing, such consideration might be more useful after the outcome of these Postal Service initiatives is known. Furthermore, other changes to the 1970 Act may be required if the Postal Service is to be competitive as discussed in our September 1994 labor-management report.

Conclusions

Today, the Postal Service is competing with communication technologies and private carriers for the delivery of services in markets that in 1970 were the sole domain of the Postal Service. Many observers believe the current ratemaking process takes too long for the Postal Service to respond to today's rapidly changing market conditions. The proposals that we and others have offered—to improve the effectiveness of the postal ratemaking process, ensure financial accountability, and give the Postal Service more flexibility to price and compete in the marketplace—provide the Postal Service, the Postal Rate Commission, and the Subcommittee with a variety of ideas to consider in reforming the ratemaking process.

Agency Comments and Our Evaluation

The Postal Service and the Postal Rate Commission provided written comments on a draft of this report. They are located in appendixes II and III. The Postal Service said that Congress should not defer consideration of the issues raised in our 1992 report while the Postal Service initiatives are pending before the Commission.[21] The Postal Service believes that the ratesetting criteria should be clarified by an explicit congressional determination that market demand factors be given substantial weight in pricing postal products. In addition, it believes that Congress should make clear through an amendment to the 1970 Act that appropriate economic factors, such as marginal costs, should be given a relatively large role in establishing an attributable cost threshold for rates.

[21]The Postal Service states that we "support" the proposal that the Postal Service has submitted to the Postal Rate Commission for changes in the ratemaking process. To set the record straight, although we believe that changes to the ratemaking process are needed, we have not endorsed any specific proposal.

The Commission said that it would welcome a review of the ratesetting criteria in the 1970 Act, and it agreed with our suggestion that Congress should defer this review until the two pending Service initiatives are concluded. The Commission said it would not comment on the merits of volume discounting because this issue is pending before it.

Regarding market-based pricing, the Commission said it disagreed with our conclusion in this report and our 1992 report that postal rates should be based to a greater extent on demand-pricing principles. The Commission had several overall criticisms of our report, saying that we produced a report that was not within our proper institutional role, that we failed to address key issues, and that we did not sufficiently understand the economic theory underlying postal ratemaking.

We do not believe that these criticisms are warranted. It is important to understand that our objective was to report to Congress on the implications of a greater or lesser reliance on demand pricing for setting postal rates, recognizing the need for balance with the pursuit of other goals. It was not our role or goal to reduce the postal ratesetting process, which is inherently complex, to a single formula or set of formulas that specifies the exact weight to be given to demand factors vis-a-vis other considerations. We have made several changes to this report to clarify this point. Because this was not our objective, we did not present an exhaustive discussion of all the technical aspects of the economics of postal ratemaking. In our 1992 report, we analyzed some of the more important issues as they relate to the application of criteria prescribed in the 1970 Act for ratemaking. The basis for our conclusions that these criteria are matters that require consideration by Congress is spelled out in the objectives, scope, and methodology section of our 1992 report and the scope and methodology section of this report.

The Commission (1) summarized what it considered to be the conclusions and recommendations of our 1992 report and this update of that report, (2) stated that our report had a “major error” because it believes the effects of Ramsey pricing on the Postal Service’s rates and long-run finances will be different than we reported, and (3) argued that the effects of demand pricing on the Postal Service’s competitiveness will be different than we reported. The Commission also said that (4) the conditions necessary for Ramsey pricing to achieve efficient consumption patterns are not met, (5) Ramsey pricing would not have a substantial effect on consumption patterns, and (6) disagreements between the Commission and the Postal Service do not necessarily imply that the ratesetting process is intrinsically defective. Below, we respond to each of these positions.

The Commission's Summary of Our Work

The Commission's summation of our work is inaccurate in certain crucial respects.[22] We never predicted that Ramsey pricing would ultimately lower rates for all classes of mail, as the Commission asserts.[23] Rather, both of our reports said that demand pricing, along with volume discounting, could help keep rates lower for most mail classes over the long term. Further, we do not agree that our conclusions would apply only in "extreme and improbable conditions," for the reasons given in the following sections.

The Commission's Concern About a "Major Error"

We do not concur with the basis for the Commission's second point, which deals with an alleged "major error" in this report. The Commission argues that, because the demand for most postal services is relatively inelastic, the effects of demand pricing on the Postal Service's rates and long-run finances will be different than we reported.

The Commission argues that the total institutional-cost contribution from competitive postal services could decrease if their markups were reduced. We agree that this could happen under certain conditions. In particular, it might happen where demand is very inelastic. While the precise magnitudes of future elasticities of demand are unknown, we do not believe that the situation described by the Commission applies to the Postal Service in the long run. Rather, we believe that, if mailers are increasingly offered alternatives and postal rates continue to increase as in the past, the Postal Service will face considerably more competition in some markets. This would likely lead to elasticities of demand that are higher (in absolute terms) than those reported for the Commission's most recently recommended postage rates (Docket No. R94-1).

Further, we question the relevance of the hypothetical example provided in footnote 5 of the Commission's letter regarding the impact of adjusting

[22]See appendix III for the Commission's comments.

[23]The critique of Ramsey pricing that runs throughout the Commission's letter might suggest to some that we recommended total reliance on Ramsey pricing, which is not the case. We stated our conclusions and matters for congressional consideration in terms of demand pricing in general, rather than the more specific Ramsey pricing, along with other factors. We used the term "Ramsey pricing" to refer specifically to prices that are set according to a formula from the literature on the economics of regulation, as we explained in our 1992 report. The term "demand pricing" refers more generically to pricing schemes that take demand factors into account.

the rates on a single mail class. Not only might the demand for various mail classes change significantly in future years, but also it is the relative elasticities that are relevant, not absolute elasticities. The Postal Service is required to operate subject to a break-even constraint. Thus, the task is one of determining the relative markup on different classes in order to achieve a systemwide average markup that just covers institutional costs. This means that the markups on all classes of mail, taken together, should cover institutional cost. When the markup on one class of mail is increased, the markup on one or more other classes of mail must be lowered to maintain a break-even operation overall, all other factors being equal.

We continue to believe that demand pricing, along with volume discounting, could help keep rates lower for most mail classes over the long term. Such pricing mechanisms could help minimize mail volume losses due to increasing competition in some postal markets. The extent of the curtailment of volume losses will depend in part on the future demand for the various classes of mail.

We do not believe that over the long term, the outcomes that we have indicated are at all improbable in light of past mail volume trends. Our 1992 report discusses how the Postal Service has already lost major market share in parcel post and Express Mail due to competition. One reason for this loss was the application of the current pricing criteria and the resulting limited ability to (1) price postal services with sufficient weight given to market factors, i.e., the relative demands for the various services, and (2) use pricing schemes that are routinely used by the Postal Service's competitors, e.g., volume discounts.

Impact of Ramsey Pricing on Competitiveness

In its third point, the Commission argues that the Postal Service's competitive position would not be improved by a shift toward Ramsey pricing. The Commission's arguments emphasize second-class mail, parcel post, Priority Mail, and Express Mail. As we noted in our 1992 report, the principal issue we discuss has been and remains the allocation of institutional cost between First-Class and third-class mail, which together accounted for 93 percent of total mail volume and 84 percent of revenue in fiscal year 1994. We believe that this is where the potential benefits of demand-based pricing will primarily be found.

Further, the Commission argues that the Postal Service will be incapable of realizing any contribution to overhead, or what the Commission calls "profit," in competitive markets over the long term. The Commission's logic is that competition will drive the rates toward the level of marginal costs, and thus drive the "profit margins" toward zero. We find this argument unpersuasive. If this logic were applied to private carriers, who are subject to similar market forces and presumably also have cost structures involving overhead or fixed costs, it would imply that their "profit margins" would also be driven to zero. However, this is implausible, at least for viable competitors over the long term, because the firms would be operating at a loss.

We agree that the Postal Service's experience in the parcel post delivery market is important, but we disagree with the Commission about the exact nature of the lesson to be learned. As we discussed in our 1992 report and in this report, at the time it was losing parcel delivery business to its competitors, the Service was limited in its ability to use pricing techniques similar to theirs. We recognize, nonetheless, that the use of different pricing techniques alone will not guarantee financial stability. As we have pointed out in this report, unless significant progress is also made in, for example, controlling labor costs and improving labor relations, the Service may still be unable to compete effectively, regardless of ratemaking changes.

Finally, the Commission said that our report noted "with approval" the Postal Service proposal for a rate increase. In fact, we merely cited the Service's view that its proposal regarding cost allocations for First-Class letters and third-class bulk mail were more in line with Ramsey pricing. It was not our purpose to approve or disapprove of any specific proposal. Also, as previously indicated, the debate surrounding cost allocations in prior rate cases has focused primarily on First-Class and third-class mail and not on Priority Mail and Express Mail, which the Commission has chosen to emphasize.

Conditions Necessary for Ramsey Pricing to Achieve Efficient Consumption Patterns

In its fourth point, the Commission argues that the conditions necessary for Ramsey pricing to achieve economically efficient consumption patterns are not present. Regarding the Commission's arguments in this area, we have several observations. First, although monopoly ratepayers may perceive that they are paying a disproportionate share of fixed costs under demand-based pricing schemes, we believe that over the longer term their rates would likely increase less under a demand-based pricing scheme than under other schemes, for the reasons we stated in our 1992 report. This view has been supported by others who have studied postal economics.[24]

With regard to the Commission's argument that Ramsey pricing is viewed by many as unfair to competitors, we repeat that we do not advocate the use of demand-based pricing, and certainly not Ramsey pricing, to the exclusion of all other considerations. To respond to concerns about fairness to competitors, the Commission would be free to use this factor in its deliberations, since it is included in the criteria specified in the 1970 Act. Further, the issue of fairness to competitors involves considerations that go far beyond ratesetting, into such areas as the existence and magnitude of the postal monopoly, and hence are beyond the scope of either our 1992 report or this report. As noted in this report, we are reviewing aspects of the postal monopoly and plan to report on that review later.

We agree with the Commission about the importance of measuring costs properly. However, if the inability to measure both stand-alone costs and incremental costs is a problem for Ramsey pricing or other demand-based pricing schemes, it would seem to be equally problematic for other types of pricing schemes. In our 1992 report, we noted the need for better cost and demand data. However, as we noted both in that report and this one, we continue to believe that decisions should be based on the best information available, and that decisions on the continued appropriateness of the rate criteria in the 1970 Act should not be postponed pending improvements in the data. Further, with regard to the Commission's statement that the Postal Service's underlying direct costs (e.g., labor costs) are not at a technically efficient level, we note that its operating costs, whether efficient or not, must be taken as a given for ratesetting purposes. Again, to the extent that this is a problem, it is equally problematic for both demand-based pricing and other forms of pricing. We did not address Postal Service workforce issues in this report; however, as noted in the text, we have done so in other recently issued reports on automation and labor-management relations.

As a final comment on the Commission's fourth point regarding the conditions necessary for Ramsey pricing, we note that the assertion that no regulatory body requires rates to conform strictly to Ramsey pricing principles is not relevant to our report. Again, we did not state that demand pricing in general, or Ramsey pricing in particular, should be used for setting postal rates to the exclusion of all other factors. As we noted

[24]See, for example, the testimony of John Panzar in the R94-1 rate case.

earlier, Ramsey pricing has received considerable attention in the academic literature, and it has been applied to varying degrees in ratesetting proceedings in regulated industries.

Impact of Ramsey Pricing on Consumption Patterns

The Commission's fifth point is that a rate structure that is derived from Ramsey pricing formulas would not affect consumption patterns in a way that differs substantially from the impact of the rate structure that the Commission actually adopted in Docket No. R94-1. In fact, we made no estimate of the impact of Ramsey pricing on consumption patterns. We are aware of the estimates that are cited by the Commission. We note that these estimates are based on short-run estimates of demand elasticities and that the long-run scenario may be quite different. Further, the Commission asserts that our draft report criticizes the Commission for its actions. In fact, our purpose was merely to describe the differences in reasoning expressed by the Postal Service and the Commission in their respective applications of the postal ratemaking criteria set forth in the 1970 Act.

Disagreements Between the Commission and the Postal Service

Regarding the Commission's observation on the differing views of the Commission and the Postal Service, we agree that regulators often disagree with regulated entities over the prices to be set in a particular case. However, our report addressed the more fundamental issue of whether the criteria established by Congress in 1970 for setting postal rates are still valid today. Critical to addressing this issue is the question of the weight to be assigned to demand factors, relative to other criteria prescribed in the 1970 Act. It is the difference in Postal Service and Commission perspectives regarding this relative weight that is of concern to us and that we believe requires consideration by Congress.

We are sending copies of this report to the Board of Governors and Postmaster General of the U.S. Postal Service, the Commissioners of the Postal Rate Commission, and other interested parties.

The major contributors to this report are listed in appendix IV. If there are any further questions or if assistance is needed, please call me on (202) 512-8387.

Sincerely yours,

J. William Gadsby
Director, Government Business
Operations Issues

Contents

Rate Criteria

The Postal Reorganization Act sets forth, in 39 U.S.C. 3622(b), the following nine criteria for determining postal rates and fee levels:

1. The establishment and maintenance of a fair and equitable schedule.

2. The value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to the collection, mode of transportation, and priority of delivery.

3. The requirement that each class of mail or type of mail service bear the direct and indirect costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type.

4. The effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters.

5. The available alternative means of sending and receiving letters and other mail matter at reasonable costs.

6. The degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service.

7. Simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services.

8. The educational, cultural, scientific, and informational value to the recipient of mail matter.

9. Such other factors as the Commission deems appropriate.

Comments From the U.S. Postal Service

MARVIN RUNYON
POSTMASTER GENERAL, CEO

UNITED STATES
POSTAL SERVICE

July 19, 1995

Mr. J. William Gadsby
Director, Government Business
Operations Issues
United States General Accounting Office
Washington, DC 20548-0001

Dear Mr. Gadsby:

Thank you for providing us an opportunity to comment on the draft report entitled, U.S. Postal Service: Postal Ratemaking In Need of Change.

The Postal Service strongly believes that the existing ratemaking process needs to be improved. To this end, the Postal Service has proposed to the Postal Rate Commission a wide variety of changes to the rules used by the Commission in recommending postal rates. We are pleased that GAO supports this approach and, along with GAO, urge that such needed administrative changes be adopted as rapidly as possible.

We disagree, however, with GAO's suggestion that Congress should defer all consideration of GAO's recommendations concerning ratemaking policy while these initiatives are pending. Without waiting for the outcome of our administrative initiatives, Congress could significantly improve the functioning of the existing ratemaking process by clarifying the criteria that currently must be considered in setting postal rates. For example, the pertinence and importance of the principles enunciated in GAO's 1992 report, U.S. Postal Service: Pricing Postal Services in a Competitive Environment, could be clarified by an explicit Congressional determination that market demand factors be given substantial weight in the pricing of postal products. It would also be important for Congress to make plain that in establishing an attributable cost threshold for rates, it intended that marginal cost and other appropriate economic factors be given a relatively large role in the ratemaking process. This is critical, since cost attribution, like the judgmental assignment of institutional costs, can easily lead to uneconomic, unbusinesslike results, if not strongly guided by sound economic principles, such as reliance on marginal costs and demand factors, in setting rates.

We believe it was the intent of Congress, in reorganizing the Postal Service in 1970, that postal ratemaking should be conducted in a manner consistent with sound economic theory and business practice. The ratemaking criteria of equity and fairness, while obviously important, should not be allowed to outweigh the need for economic rationality. This is especially important today, when the communications marketplace in which the Postal Service operates is vastly more competitive than that of the late 1960s and early 1970s.

Even if, as GAO suggests, Congress were to defer consideration of the major issues of increased statutory flexibility needed by the Postal Service in today's communications marketplace, Congress should still reaffirm that the flexibility to set postal rates in a sound, businesslike manner is inherent in the existing statutory framework.

If you wish to discuss any of these comments, my staff is available at your convenience.

Best regards,

Marvin Runyon

Comments From the Postal Rate Commission

POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

EDWARD J. GLEIMAN
CHAIRMAN

July 24, 1995

Mr. J. William Gadsby
Director, Government Business Operations
General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Gadsby:

Thank you for the opportunity to comment on your draft report entitled *U.S. Postal Service: Postal Ratemaking in Need of Change* (GAO/GGD-95-134) (the Draft). I welcome the Draft's call for review of the rate-setting criteria in the Postal Reorganization Act (the Act). I concur in its suggestion that this review should be deferred until the conclusion of two pending proceedings.[1] However, I cannot concur in the Draft's conclusion that postal rates should be based to a greater extent on demand pricing principles, or its suggestion that the Postal Rate Commission (Commission) has given insufficient weight to demand considerations in the past.

In a report prepared last year for the Committee on Governmental Affairs of the United States Senate, the National Academy on Public Administration warned that "GAO's credibility and authoritativeness will be eroded by its involvement in policy areas without a solid base in research and evaluation." The report urged "restraint on the part of GAO . . . to avoid reports that do not have a firm factual base within GAO's competence." It noted that "the closer GAO comes to value-laden policy issues on which consensus is lacking, the more cautiously it should proceed and the more emphasis it must give to developing a solid, reliable factual basis for its analysis." Finally, the report concluded "that GAO has on occasion moved too far into advocating policy, pushing into policy formulation more appropriate to elected officials and then urging congressional acceptance of GAO recommendations."[2]

This Draft, and the 1992 GAO report on postal pricing policy which it updates,[3] unfortunately, together illustrate the accuracy of the findings of the National Academy of Public Administration report. As explained below, GAO has produced a report that does "not have a firm factual basis within GAO's competence." GAO's work does not address many matters of key importance, and it lacks both depth and perspective in the understanding and application of economic theory associated with postal ratemaking.

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[1] *Mail Classification Schedule, 1995, Classification Reform I*, Docket No. MC95-1; *Procedures Applicable to Limited Scope Cases*, Docket No. RM95-4.

[2] *The Roles, Mission and Operation of the U.S. General Accounting Office*, Report prepared for the Committee on Governmental Affairs, United States Senate, by the National Academy of Public Administration, 103d Cong., 2d Sess., pp. i, 49.

[3] *U.S. Postal Service: Pricing Postal Services in a Competitive Environment* (GAO/GGD-92-49).

Mr. J. William Gadsby
July 24, 1995
Page 2

1. The Draft and the 1992 Report.[4]

In the 1992 report, GAO concluded that the Postal Service's financial stability and its competitive position are threatened by the Commission's failure to follow Ramsey pricing principles (pricing services in inverse proportion to their relative demand). It recommended that the Postal Reorganization Act be amended to make it clear that demand considerations could dominate postal pricing without conflicting with the other pricing criteria in the Act. After considering the Commission's pricing recommendations in its most recent general rate case (Docket No. R94-1), the Draft adheres to the conclusions in GAO's 1992 report.

The Draft reaffirms the position of GAO's 1992 report that Ramsey pricing would shift some of the Postal Service's institutional cost burden from its competitive services to its monopoly services, reducing rates for the competitive services, increasing total volume, and spreading the Postal Service's institutional costs over more pieces. These reports predict that this would ultimately lower rates for all classes of mail and make the Postal Service more financially stable. They do not, however, acknowledge that extreme and improbable conditions in postal markets would have to exist before Ramsey pricing could have this result. Absent these conditions, the long term result of Ramsey prices would be substantially higher rates for the monopoly services (primarily First-Class), lower rates for some competitive services, and no improvement in the Postal Service's financial stability.

2. GAO's Major Error

GAO argues that Ramsey pricing would cause the total institutional cost contribution, or "profit," from competitive postal services to increase as a result of reducing their markups or "profit margins." Specifically, GAO holds out the prospect that in the long run, the volumes of

[4] The Draft also suggests Congress should determine if volume discounting by the Postal Service should be considered a discriminatory pricing policy. Volume discounting is an issue in *Procedures Applicable to Limited Scope Cases*, Docket No. RM95-4, pending before the Commission. Accordingly, this letter does not address the merits of that subject. Neither does this letter comment on recommendations of others summarized in the Draft (e.g., *The Ratemaking Process for the U.S. Postal Service*, report of the Institute of Public Administration to the Board of Governors of the U.S. Postal Service (New York: Institute of Public Administration, Oct. 8, 1991); *Postal Ratemaking in a Time of Change*, a report by the Joint Task Force on Postal Ratemaking submitted to the Board of Governors of the United States Postal Service and the Postal Rate Commission, June 1, 1992). The Commission has commented on the issues raised in these reports on other occasions. See, e.g., Testimony of Edward J. Gleiman, Chairman, Postal Rate Commission, before the Subcommittee on the Postal Service, Committee on Government Reform and Oversight, U.S. House of Representatives, March 2, 1995.

Mr. J. William Gadsby
July 24, 1995
Page 3

the competitive services would increase so dramatically that they would increase their total contribution to institutional costs despite their reduced markups. This, in turn, would decrease the total contribution required from the monopoly services. But this can happen only if the demand for such services is extremely elastic.[5] The record in Docket No. R94-1 shows that, with one minor exception, the demand for all postal services, whether they are competitive or monopolized, is inelastic.[6] Accordingly, reducing the rates for competitive services further would decrease, rather than increase, their total contribution to institutional costs. To offset this loss, a larger total contribution to institutional costs would be required from the monopoly services. This scenario would not change unless the demand for competitive postal services is transformed from inelastic to substantially elastic. Such a transformation is not reasonably foreseeable.[7]

3. Impact of Ramsey Pricing on Competitiveness.

The Draft's authors assume that the Postal Service's competitive posture would be improved by a shift toward Ramsey prices. In support, they point out that the Ramsey price for third-class mail would have been lower than that recommended by the Commission. GAO is apparently unaware that the Commission's recommended rates for second-class mail and parcel post were actually lower than their Ramsey prices.[8] For these highly competitive classes, at least,

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[5] In order for a rate decrease to cause an increase in net revenue, some of which could be used to lower the rates for another subclass, the absolute value of the own-price elasticity must be greater than the rate divided by the difference between the rate and the attributable cost. Thus, a subclass with a rate of 12 cents, and a cost of 9 cents, would be required to have an elasticity of at least 4.0 to be a candidate for a rate reduction. Given the existing markups for the various subclasses of mail, their elasticities would have to more than double (in most cases, more than triple) before reducing their rates could increase the net revenue that they generate. The lower the markup, the greater the increase in elasticity that would be necessary. The elasticity of parcel post, for example, would have to increase 15-fold before reducing its rate would increase the net revenue that it generates.

[6] The Postal Service's elasticity estimates in Docket No. R94-1 are found throughout the testimony of witness Tolley (USPS-T-2), and are summarized in the Commission's Docket No. R94-1 Opinion at Appendix F, page 6 of 24.

[7] The 1992 GAO report recognizes that the financial future of the Postal Service depends primarily on trends in First-Class and third-class mail. No postal observer expects the highly inelastic demand for First-Class Mail to become elastic in the foreseeable future. Demand for regular rate third-class mail, already substantially inelastic, has been growing more inelastic over the last decade (1984-1994), according to Postal Service estimates.

[8] The Draft's authors appear to assume that the more competition a service faces, the lower its Ramsey markup will be, and the more competitive it will become. The testimony of Advertising

Mr. J. William Gadsby
July 24, 1995
Page 4

giving more weight to the Ramsey model would make it more difficult for the Postal Service to compete, not less.

Parcel post illustrates the likely future role that the competitive services generally can play in the Postal Service's search for financial stability. Its markup (which may be viewed as its "profit margin") has been reduced well below that of the monopoly services in order to allow it to meet competition. GAO assumes that in the future, competition will intensify in the markets for competitive postal services generally. If so, those markets will increasingly resemble the parcel delivery market. Competition will drive the rates toward the level of marginal costs, and drive their "profit margins" toward zero. In the process, the competitive services will lose their ability to contribute anything to the Postal Service's institutional costs. It is difficult to discern the logic in the Draft's conclusion that further reducing rates for its services that are the most competitive and the least profitable will make the Postal Service more financially stable.

The Draft discusses the proposed across-the-board 10.3 percent increase in postal rates that the Postal Service proposed in Docket No. R94-1. It notes with approval that this would have resulted in relative rates for First-Class and third-class mail that were more in line with Ramsey pricing than the rates recommended by the Commission. The Draft fails to recognize that with respect to some services more vulnerable to competition, such as Priority Mail and Express Mail, the Postal Service's proposal disregarded Ramsey pricing theory, and missed an important opportunity to make these rates more competitive.

4. Conditions Necessary for Ramsey Pricing to Achieve Efficient Consumption Patterns.

The purpose of Ramsey pricing is to minimize the loss of consumer welfare in the economy as a whole. Ramsey pricing is based on the theory that setting prices equal to marginal costs would produce an "ideal" pattern of consumption throughout the economy that would maximize consumer welfare. The theory recognizes, however, that a natural monopoly must "mark up" prices above marginal cost to pay for its substantial fixed (institutional) costs. Ramsey prices, therefore, are designed to mark up the direct costs of a monopoly firm's services in a way that alters the "ideal" consumption pattern for those services as little as possible. It generally marks up services in inverse proportion to their elasticity of demand.

The use of Ramsey prices is highly controversial in regulatory circles. The Commission is not aware of any regulatory body that requires rates to conform to Ramsey prices. In part, this is because applying Ramsey prices to firms that serve both monopoly and competitive markets assigns a disproportionate share of fixed costs to the monopoly ratepayers. This is viewed by many as unfair, since monopoly ratepayers have no choice but to pay the disproportionate share.

Mail Marketing Association witness Lenard in Docket No. R94-1 (AMMA et al.-RT-1), Exhibit IV, makes it clear that this is not a valid assumption with respect to second- and fourth-class mail.

Mr. J. William Gadsby
July 24, 1995
Page 5

Ramsey pricing is also viewed by many as unfair to competitors, who do not have monopoly markets as a source of surplus revenue to support aggressive price-cutting in competitive markets.

Another reason that regulatory bodies do not apply Ramsey prices is that they will not result in efficient consumption patterns unless certain conditions are met. It cannot be shown that the Postal Service meets these conditions. For example, before Ramsey prices can function as intended, it must be shown that they would not cause monopoly services to pay part of the direct costs of competitive services. Such cross-subsidies damage competitive markets by discouraging efficient competitors from entering. To guard against the inefficiency that cross-subsidy entails, it must be shown that the Ramsey price for a service is below its "stand alone" cost (the amount that a single-product firm would spend providing the service) and above its "incremental" cost (the amount that a multi-product firm would save if it discontinued the service). The Postal Service cannot show that Ramsey prices would meet either condition, since it does not know the stand-alone or incremental cost of any of its services. Similarly, Ramsey prices cannot achieve the economically efficient consumption pattern that they are intended to achieve unless the underlying direct costs (e.g., labor costs) are at technically efficient levels. This should not be assumed, since it is generally recognized that the Postal Service's labor costs are well above those of its competitors.

5. Impact of Ramsey Pricing on Consumption Patterns.

The Draft criticizes the Commission for not going as far as the Postal Service requested in Docket No. R94-1 toward recommending rates that conform to Ramsey pricing principles. Ramsey pricing theory assumes that the ideal pattern of consumption in the economy as a whole is the one that would result if no institutional costs (overhead) were charged for a monopoly's services. The purpose of Ramsey pricing is to allocate overhead costs in a way that changes this "ideal" economy-wide pattern of consumption as little as possible. In terms of that purpose, there is no meaningful difference between the rates proposed by the Postal Service and those that the Commission recommended in Docket No. R94-1.[9]

[9] In Docket No. R94-1, Advertising Mail Marketing Association (AMMA et al-RT-1, pp. 39-40; Workpaper 5) witness Lenard presented a method for approximating the impact of various sets of proposed rates on the Ramsey "ideal" pattern of consumption. Based on his method, the Commission has compared the impact on the "ideal" consumption pattern of rates it recommended in Docket No. R94-1 and the rates that the Postal Service proposed. The impact differs by one-twentieth of one percent of annual postal revenues. Accordingly, if the Postal Service's proposed rates are considered preferable to those recommended by the Commission in Docket No. R94-1, it must be on some other basis.

Mr. J. William Gadsby
July 24, 1995
Page 6

6. Differing Views

Finally, the concern expressed in the Draft about disagreement between the Commission and the Postal Service over pricing policy seems gratuitous. It is not uncommon, and generally is perceived as healthy, for the regulated to disagree with the regulator.

Please know that I appreciate the efforts of your staff to address deficiencies noted in an earlier draft when we met several weeks ago.

Sincerely,

Edward J. Gleiman

Edward J. Gleiman

cc: Honorable Charles A. Bowsher
Comptroller General of the United States

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