

**Implementing a Modern System of Regulation for the Postal Service under
the Postal Accountability and Enhancement Act**

by

Frank A. Wolak
Department of Economics
Stanford University
Stanford, CA 94305-6072
e-mail: wolak@zia.stanford.edu

Draft: February 25, 2008

1. Introduction

The Postal Accountability and Enhancement Act (Postal Reform Act) proposes to implement a modern system of regulation for the Postal Service that controls the price of both market dominant products and competitive products, yet still allows the Postal Service an opportunity to recover its total production costs through the sale of these products. In order to streamline the regulatory price-setting process, the Postal Reform Act also allows the Postal Service greater flexibility in pricing individual products and offering new products.

A modern system of regulation attempts to balance two competing goals: (1) providing strong incentives for the regulated firm to produce its output in a least-cost manner, and (2) protecting consumers from excessive prices for postal services that reflect the exercise of monopoly power by the Postal Service. The cap on total annual price increases in the Postal Reform Act is designed to achieve both of these goals. The maximum annual increase in price limits the amount that the Postal Service can increase prices each year. Price cap mechanisms that restrict the maximum percentage price increase that the regulated firm can implement over last year's price using the Consumer Price Index (CPI) provide strong incentives for a privately-owned regulated firm to produce in a least-cost manner. The firm's output price and therefore its revenues are largely independent of its own actions, so the only firm-level actions that can increase its profits are those that reduce total production costs.

Consequently, if the Postal Service was a privately-owned profit-maximizing firm, its desire to maximize profits would provide strong incentives for it to produce in a least-cost manner. However, government ownership of the Postal Service makes it extremely difficult for the price-cap regulatory mechanism in the Postal Reform Act to provide incentives for least-

cost production. Unless the Postal Regulatory Commission fully exploits the subpoena power of the Postal Reform Act to request accurate and appropriate data from the Postal Service and uses this information to perform prospective reviews of proposed rate increases, it will be very difficult, if not impossible, for the Postal Regulatory Commission to achieve the pricing goals of the Postal Reform Act. Finally, the Postal Service's universal service obligation further complicates achieving the goals of least-cost production and efficient pricing.

The purpose of my testimony is to explain the challenges faced by the Postal Regulatory Commission in implementing a modern system of regulation. I then describe what actions the Postal Regulatory Commission can take within the mandate of the Postal Reform Act to balance the two competing goals of a modern system of regulation. I then describe the challenges in defining and satisfying the Postal Service's universal service obligation and still achieve the goal of a modern system of regulation. Finally, I describe why pro-active collection and analysis of accurate and appropriate postal operations and cost data is essential to an effective regulatory process under the framework specified by the Postal Reform Act.

Implications of Government Ownership of the USPS

Regulatory mechanisms that provide strong incentives for least-cost production typically rely on the existence of a residual claimant that can exercise control over the firm's management. For privately-owned firms, shareholders are the residual claimants for any revenues greater than the sum of the firm's variable costs of production and debt obligations. The combination of the firm's owners demanding the highest possible return on their investment and a price cap mechanism which sets the maximum output price the firm can charge, yields very high-powered incentives for the firm to reduce its production costs.

A government-owned firm, such as the Postal Service, does not have a residual claimant with the ability to provide the firm's management with incentives to achieve the highest possible return on investment. Different from a privately-owned firm, there are no mechanisms for the citizens of the United States to sell their ownership stake in the Postal Service or replace its managers if they are unhappy with how the Postal Service is being operated.

The lack of a residual claimant also makes it extremely difficult for the Postal Regulatory Commission to reduce the revenues that the Postal Service is allowed to earn if it believes that the Postal Service is not being managed in an efficient manner. In contrast, for privately-owned firms, the regulator has the option to reduce the firm's allowed revenues, which reduces the return received by the firm's shareholders. The risk of a reduced return on investment for the firm's shareholders provides strong incentives for the firm's management to produce in a least-cost manner. If the shareholders do not receive an adequate return they can replace the firm's management or sell their ownership stake in the firm, which makes it more costly for the firm's managers to raise money for any new investments.

The Postal Service is also severely limited, relative to a privately-owned firm, in its ability to provide financial incentives for its managers to take actions to maximize operating profits. Shareholders of private firms often offer substantial bonuses to management and the threat of a job loss to align the incentives of the management with their desires as the firm's residual claimant. Under the Postal Reform Act, the Postal Service is limited in its ability to reward and punish management for the performance of the Postal Service.

Consequently, the price cap mechanism in the Postal Reform Act is unlikely to cause Postal Service to produce in a least-cost manner. At best, this mechanism protects consumers

from excessive prices for both market dominant and competitive products. However, if there are opportunities for cost reductions or total factor productivity growth improvements known only to the Postal Service, the price cap mechanism in the Postal Reform Act may allow the Postal Service to set prices higher than those necessary to recover its production costs with these cost reductions factored in. This risk of setting prices that are too high is particularly great during the initial stages of the implementation of the price cap mechanism because there may be one-time opportunities for cost reductions and productivity improvements, the benefits of which will not be passed on to postal consumers, because the ownership structure of the Postal Service results in its management having little incentive to realize them.

Role of Information Provision in Effective Regulation

As the above discussion demonstrates, the price cap mechanism alone is unlikely to allow the Postal Regulatory Commission to achieve the twin goals of a modern regulatory process--least cost production, and no exploitation of monopoly pricing power. Fortunately, there are other features of the Postal Reform Act that can be used to achieve these goals. The most important is the subpoena power of the Postal Regulatory Commission to request information from the Postal Service. Others include the requirement for the Postal Service to submit detailed annual reports to the Postal Regulatory Commission and provide it with access to any working papers and any other supporting matter used to prepare these annual reports.

Use of this subpoena power by the Postal Regulatory Commission to obtain data on the financial health and operating efficiency of the Postal Service is crucial to providing strong incentives for least-cost production by the Postal Service and protecting consumers from prices

that cross-subsidize competitive products or are in excess of those necessary to recover the Postal Service's production costs.

The Postal Regulatory Commission can use information about postal operations that it obtains to provide "smart sunshine regulation" of the Postal Service. I define "smart sunshine regulation" as the collection and analysis of detailed information on postal services operations and production costs in a manner that allows the Postal Regulatory Commission, major postal consumers, and other interested parties to monitor on an ongoing basis the performance of the Postal Service over time and across postal processing locations to improve the effectiveness of all aspects of the postal regulatory process.

An important role of the Postal Regulatory Commission is to ensure that market-dominant postal products are not cross-subsidizing other postal products. This requires determining the volume-variable costs and product-specific fixed costs associated with all Postal Service products and then verifying that the price charged for each of these products exceeds its average incremental cost (the sum of the volume variable costs and product specific fixed costs divided by the number of units of this product produced). An essential input into the process of computing these product specific costs is highly accurate, detailed data on postal operations. In previous rate cases, the Postal Rate Commission has identified significant errors in several of the data sources used by the Postal Service in their mail processing cost studies.

Having the ability to subpoena information from the Postal Service would allow the Postal Regulatory Commission to gain a better understanding of both the magnitude and causes of these data quality issues. Postal Regulatory Commission could obtain the raw data underlying the data used in the cost studies or request information from other Postal Service

sources that could shed light on these data errors and ultimately improve the accuracy of the operations and cost data provided by the Postal Service.

Accurate operations and cost data from the Postal Service is an essential for the Postal Regulatory Commission to carry out a number of its other duties under the Postal Reform Act. Detailed and accurate cost information is also necessary to determine the contribution each product makes to recovery of the Postal Service's common costs. The Postal Reform Act requires the Postal Regulatory Commission to monitor the actual contribution of competitive versus market dominant products and determine the appropriate level for this contribution on an ongoing basis.

The Postal Service is also required to pay taxes on the income it earns from sales of competitive products. Assigning fixed-costs and volume-variable costs to competitive and market-dominant products is a key step in determining the Postal Service's tax liability. Accurate and appropriate cost data is essential to this task.

To fulfill its statutory mandate, the Postal Regulatory Commission must be confident that all of the above-mentioned calculations are being performed with the most accurate operations and cost data available. It can only be sure of this if it has access to the raw data and the sampling schemes used to compile this data. The Postal Regulatory Commission can be assured of receiving this information only if it has the ability to subpoena it from the Postal Service.

As noted earlier, a key feature of a modern regulatory process is to provide strong incentives for the firm to produce in a least-cost manner. The Postal Regulatory Commission can use its ability to gain access to Postal Service data to perform productivity studies and

benchmarking studies. For example, the Postal Service performs a number of identical mail processing operations using almost identical technology at different geographical locations across the United States. The Postal Service's data, however, show that the productivity of those operations varies widely across locations. Quantifying the magnitude, and identifying the causes of these wide productivity differences across processing plant locations can provide valuable input to Postal Service to improve its overall productive efficiency and reduce its total production costs.

A final, but very important, regulatory benefit of the Postal Regulatory Commission having the ability to issue subpoenas to the Postal Service is the fact that the Commission can use this information to prepare and disseminate reports on the performance of the Postal Service that provide guidance for improving the efficiency of postal operations. These analyses could be released to the public in a form that would not compromise the Postal Service's ability to compete, but it would provide key performance measures that large postal consumers and government oversight agencies can monitor to gauge the extent to which the Postal Service is producing in a least-cost manner and not setting prices that cross-subsidize certain Postal Service products.

This extensive data collection and analysis effort by the Postal Regulatory Commission can also allow it to make more informed decisions about the need for postal rate increases proposed by the Postal Service under the price cap mechanism. The Postal Reform Act gives the Postal Regulatory Commission the duty to perform an ex ante review of a proposed postal rate increase under a tight deadline, as well as the ex post review described above. If the Postal Regulation Commission has compiled and analyzed all relevant operations and costs data on an

ongoing basis this will allow the best possible ex ante assessment of the benefits and costs of postal rate increases proposed by the USPS during the initial ex ante review period. This sort of information would be very valuable to Postal Regulatory Commission in preparing an initial response to the recently announced Postal Service price increases.

Because financial incentives cannot be used in the same manner as in the private sector, the Postal Regulatory Commission can make use of “smart sunshine regulation” to provide incentives for efficient postal operations and improved estimates of product-specific costs that are essential to a number of the Postal Regulatory Commission’s duties under the Postal Reform Act. Using its ability to gain access to and analyze data on postal operations can shine the light of public scrutiny on inefficient postal operations or actions that raise the prices postal consumers must pay with no corresponding public benefit. Using this mechanism, the Postal Reform Commission can provide strong incentive for least-cost production by the Postal Service and ensure that Postal Service prices only recover these production costs.

Operations Data and the Universal Service Obligation

Another duty of the Postal Regulatory Commission under the Postal Reform Act is to determine as precisely as possible the cost of the Universal Service Obligation (USO). This is an extremely challenging economic modeling task. The cost of Postal Service operations must be estimated with and without the USO imposed. This requires intimate knowledge of postal operations and the factors determining postal costs. Having the ability to request and receive information from the Postal Service will allow the Postal Regulatory Commission to produce the best possible estimate of this magnitude.

The Postal Regulatory Commission must also propose revisions to what constitutes the USO. This will require measuring the costs versus benefits of actual and proposed features of the USO, which will also require even more intimate knowledge of postal operations and how Postal Services costs are determined.

By making USO costs as transparent as possible to postal consumers and the public at large more informed decisions can be made about precisely what the USO should be. The rapid growth of competitors to the products and services provided by the Postal Service implies that the benefits of informed decisions about all dimensions of the USO could yield significant benefits to postal consumers.

Effectiveness of Commission Review of Non-Rate Cap Issues

A weakness in the regulatory scheme established by the Postal Reform Act could arise if the Postal Regulatory Commission were to decide not to examine issues other than rate-cap compliance at the time that the Postal Service proposes new rates. If the Commission were to rely almost exclusively on after-the-fact scrutiny of such issues, it is difficult to see how such scrutiny could be effective.

For example, the Postal Service could propose to implement rates that satisfy the cap for a particular class as a whole. For some products within the class, however, it could propose rates that are non-compensatory, or propose discounts that are greater than the savings they are supposed to reflect. I understand that there examples of both in the rates that the Postal Service proposed last week. [It appears that the rates proposed for Standard parcels and some components of Parcel Post do not cover their costs as measured by the Postal Regulatory

Commission. It also appears that discounts for several tiers of First-Class presort discounts exceed the costs that they avoid as measured by the Postal Regulatory Commission.]

If the Postal Regulatory Commission defers analysis of these aspects of new rates until after they are implemented, and addresses them only after a complaint is filed or its annual compliance report is issued, it is unlikely that the Postal Regulatory Commission can fashion a meaningful remedy. Scrutiny in the context of a complaint or of the annual compliance report is likely to take several months to complete if input from the various stakeholders is to be solicited and adequately taken into account. Any rate revision that the Commission might order would take several additional months of software preparation by private industry before it could be implemented. Consequently, it is doubtful that any correction that the Commission might order could be implemented for more than a month or two before the Postal Service files a new round of rate increases. If corrected rates are unlikely to ever be in effect for more than a month or two, the Commission is unlikely to order them.

The solution to this dilemma is for the Commission to undertake a meaningful analysis of non-rate-cap issues before rates proposed by the Postal Service go into effect. The above logic demonstrates the crucial importance to effective regulatory oversight of the Postal Service of a pro-active data collection and analysis effort by the Postal Regulatory Commission of all aspect of Postal Services operations. A key goal of this process is to ensure that the Postal Regulatory Commission has the most accurate and appropriate data available to carry out its statutory obligations.

Concluding Comments

The Postal Accountability and Enhancement Act provides an opportunity to implement a regulatory process for the Postal Service that increases the efficiency of postal operations, produces the best possible estimates of product-specific costs to ensure that there are no cross-subsidies in the pricing of postal products and that competitive products make an appropriate contribution to the recovery of the common costs of Postal Service operations, limits postal price increases to only those necessary to recover total Postal Service costs, and produces the transparent estimates of the current and future costs of the universal service obligation.

These goals can only be accomplished if the Postal Regulatory Commission has the ability to obtain the best possible information about postal operations and can pro-actively use this information in its decision-making process and to prepare reports that it makes available to the public. As discussed above, the usual capital market discipline and competitive pressure that provides strong incentives for efficient operation and prices that only recover efficiently incurred production costs cannot operate for the Postal Service because it has a government-owned statutory monopoly over most postal delivery services. The oversight of the Postal Regulation Commission and its ability to issue subpoenas and require periodic reports by the Postal Service can be used to provide these incentives for efficient operation and prices that only recover production costs.