

Designing a Rate-Setting System

When the Postal Accountability and Enhancement Act (PAEA) became law last December, it started a chain reaction that is going to fundamentally alter the Postal Service. Based on the notion that the Postal Service should become more of a business, the Act ends the break-even mandate of the Postal Service and allows it, for the first time in the history of the United States, to actually *make a profit*, and to keep that profit and give out bonuses. That is what this new law is all about—changing incentives.

Granted, the Postal Service is still to be considered a public service in the sense that its mission is to offer services to all Americans, in every nook, cranny, and hamlet in the United States. But the Postal Service is now supposed to be run on a profit-making basis, not a non-profit basis, and if you have ever looked at the way both are run, there is an *enormous* difference. In order to allow the Postal Service to run on a profit-making basis, the new law has largely price-deregulated the Postal Service, and removed public policy considerations from its pricing. In doing so, the clear intent of Congress was to eliminate the lengthy, arduous, and complex litigation that has surrounded postal rate-making over the last three decades.

Looking back over my 15 years of involvement with postal

reform, I find that the principal reason that all this actually *happened* is that electronic communications of all sorts (land-line telephone, cell, fax, cable, e-mail, Internet browsing, and text-messaging) have changed how we communicate and have truly altered the role the Postal Service plays in society. Put simply, the Postal Service is no longer the only game in town. That means that—lord forbid—should the Postal Service ever falter, American society and the American





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economy would not completely crash and burn. Many would suffer, and many would hurt, but they would survive. That wasn't necessarily true 60 years ago.

The PAEA reflects that reality and in light of it, opens the door for the Postal Service to act more like a business. A major part of that change is giving the Postal Service the ability to accept more "risk" in its pricing that would have been acceptable decades ago. In line with this change, the law has eliminated the old "cost-of-service" rate-making system, replaced it with a price cap system. Of course, rates have to cover attributable costs—retrospectively and on a class by class basis—but once they do that, the intent of the law is to allow the Postal Service to price as it sees fit. That means giving the Postal Service enough flexibility in pricing so that it can make mistakes—even big mistakes. That is, after all, how we all learn.

Some in the postal community, including—I suspect—some on the staff of the Postal Regulatory Commission, find this prospect a bit unsettling. Nevertheless, it is exactly what the PAEA intends. The object of the is not to maximize economic efficiency, nor to be "fair and equitable," but to give the incentive to the Postal Service to make money, as much as possible. Under such a system, the Postal Service might or might not price as consumer groups might prefer, or as economists might prefer, or as mailers might prefer, or as Postmasters or unions might prefer, or as the commission might prefer, and that is just fine. The hard fact of pricing like a business means that the Postal Service should price to maximize profit for itself. That will often involve giving the lowest price to those who will make

the Postal Service the most money. That is the *quid pro quo* that was given to the Postal Service, in exchange for forcing it to price at or under inflation, and for allowing it to price in a way that will allow it to prevent losing everything to electronic communications. If that attitude is not fully enthusiastically embraced by the commission, this new system is not going to work. This would put the jobs of all Postmasters, postal supervisors, postal carriers and postal clerks at risk, to say nothing of the health of the mailing industry.

Of course, like many complex pieces of legislation, the devil is in the details and Congress, in its infinite wisdom, has left the details to be worked out by the Postal Regulatory Commission through Notice and Comment Rulemaking. That process is now in full swing. I guess it is not surprising to see that some parties in the postal community have not accepted the hard choices that Congress made. Those parties are arguing that the commission should interpret the law in a way that doesn't free the Postal Service to price as it wishes, but keeps it in a narrow, strict, straight-laced, regulated pricing system. One such party is the Office of the Consumer Advocate (OCA), a bureau of the PRC. Another is Valpak, a distributor of local letter-shape advertising mail. There are one or two others who would like the commission to add an economic gloss to the law that would say that certain discounts must comport with the theory of Efficient Component Pricing—as contrasted to



other economic theories. None of these positions is, in my view, consistent with the deregulatory nature of pricing under the PAEA.

I will discuss the OCA and Valpak comments in the remainder of this article, for these are the two sets of comments that stray the furthest from my view of the nature and intent of the new law. As a disclaimer, I need mention that in addition to representing the National League of Postmasters as its Legislative Counsel, I represent several First-Class bulk business mail interests and have made part of my living participating in the lengthy, arduous, and complex litigation. I, for one, will not miss it, although my pocketbook probably will.

OCA

The OCA begins its comments to the rate commission by saying that that the 10 months that the commission has had in the past to set rates has been radically reduced, and this reduction "necessitates a radical new paradigm" that will allow the commission to fulfill its mission of "setting" rates "within the context of broad policy criteria." The OCA goes on to suggest that the commission "approve a series of rate-making approaches" for the Postal Service to use to set rates. Indeed, OCA says that by "pre-approving certain rate-making methods, the commission would create incentives for the Postal Service to conform to the commission's

Continued on page 10

Rate-Setting System

Continued from page 9

views on proper rate relationships—even though the PAEA delegates all initial rate-making authority to the Postal Service.” Included in the OCA’s suggestions are a variety of regulatory methods, including using efficient component pricing, per piece access charges (DACs), universal service fees (USFs), and other approaches.

While OCA’s approach is interesting and very creative, it is an approach that is inconsistent with the PAEA, and the mission of the PRC under that Act. The mission of the PRC under the PAEA is not to set rates within the context of broad policy criteria. Indeed, it is no longer even the mission of the PRC to “set” rates. The commission is there to police the Postal Service, should it step beyond its bounds, but it is no longer a “rate” commission, as the change in its name signifies.

In terms of rates, the two major questions the PRC needs to ask are whether rate increases are above inflation and whether rates are covering costs, the latter being a question asked mostly retrospectively. Those are questions whose answers can be determined in hours, not days, weeks or months.

The PAEA does contain a section which sets forth a series of public policy objectives and factors, but that section makes it quite clear that the commission has to consider those objectives and factors in setting up the new rate-setting scheme. The section also makes it quite clear that those factors apply to setting up the *system*, not to actually setting the rates.

Businesses don’t price to create economic efficiency, nor to implement public policy. Businesses price to make money. They price to make money by appropriately placing their products in the marketplace. This is why basic marketing courses teach that pricing is one of the four “Ps” of marketing—the others being product, placement, and promotion—and that is why the Postal Service pricing function correctly falls under the Postal Service’s marketing department, and not under the PRC.

The OCA’s Comments dwell on the notion of “proper rate relationships.” The OCA assumes that under the new law the commission should be concerned about the proper relationship between different classes of rates and different rates within those classes, as it was under the old law. That view misses the mark. The Postal Service is supposed to position its products in the market, as it sees fit, regardless of any per-conceived notion of relationships between rates. Thus, relationships between rates depends should depend on what relationships maximizes the Postal Service’s profit, and that is a call that, under the new law, the Postal should make, not for the PRC. If the new law hadn’t deregulated postal pricing, then the OCA’s Comments would have much more force, for they do posit a number of interesting and alternative ways to set rates, if rate-setting were still tightly regulated. But they are not.

There are two exceptions to this idea that the Postal Service should not be concerned with rate relationships. One concerns the relationship between what the new law calls “market-dominant” and “competitive” rates. Competitive rates are most parcel rates, Express mail rates, and Priority rates. “Market-dominant” rates are all the others. The PRC does need to take into account the relationship between the amount of contribution to overhead costs that “competitive rates” should pay.

The other exception concerns any rate discount that is a pure work sharing discount. Those discounts must not reflect anything beyond 100 percent of “avoided costs,” although rates designed to reflect both “avoided” and “non-avoided” costs can obviously reflect cost-saving characteristics that go beyond “avoided costs.” If the Postal Service were not allowed to do this, then the Postal Service is not being allowed to maximize its profits, and all postal employees could be in trouble.



To be fair about all this and to be fair to the OCA, it is important to realize that the OCA is an internal bureau of the Postal Regulatory Commission, and did not play an active role in postal reform, or in the postal reform debate over the last decade and a half.

Because of this, the OCA is, realistically, not in “touch” as much with the philosophy and attitude behind postal reform that has been hashed out on Capitol Hill over the last decade and a half—endlessly it seems—and embedded in the PAEA. The OCA has not spent the years, as other parties have, adjusting to the fundamentally different pricing notions that the PAEA has embraced and made the law of the land.

Once the reality of this brave new world sinks in, one hopes that the OCA will accept the fact that the postal pricing function has radically changed, and accept its role in the new structure. It is a role that is very important, but it is a role that should have less of a focus on pricing and more of focus on other matters, such as service standards. Service quality—an area where the OCA will find broad support among the mailing community—would be a very profitable and extremely critical area in which the OCA should focus its resources and energies in the future.

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Valpak does not like the new law, nor the deregulatory philosophy behind the new law, and that is evident in its comments. At practically every step of the way, it urges the commission to resist adopting the underlying philosophy of the new law. Inherent in the Valpak mentality—although it is never actually stated—is an paternalistic attitude that the Postal Service, much like an errant child, is incapable of making its own decisions. The proper way to handle such children, Valpak appears to believe, is for the parent (the commission) to make the major decisions for the child (the Postal Service), whether the child likes it or not. Such paternalism of the philosophy embedded in the new law.

Valpak suggests, much like the OCA, that the complex series of objectives, factors, and requirements that the law set forth for the commission to consid-

er in designing the new system should be reexamined and rebalanced “every time the Postal Service proposes an increase in rates.” How it gets to that point, given the plain language of the PAEA—which says these objectives and factors shall apply to the designing of the rate system—is a bit beyond me.

Nevertheless, the bottom line for Valpak, is that all the “progress” that has been made in the litigation of rates over the last several decades need not go to waste and that none “of this progress needs to cease under the PAEA.” Valpak and its attorneys, it would seem, would like the litigatable nature of postal rate-making to proceed uninterrupted by such things as congressional action and congressional intent. Indeed, Valpak echoes the OCA is wanting the commission to “allow the Postal Service at any time to propose an improvement to a commission-

approved analysis or method,” and wants a four month period to litigate the Postal Service’s “proposal.” Again, the notion of “commission-approved” pricing and four months of rate litigation is not consistent with the nature of the PAEA.

If the rate increases proposed by the Postal Service are under inflation, and if rates do not clearly fall below costs, the major line of inquires for the commission should really end there. The time spent for such an inquiry should be measured as a matter of hours, not days or weeks or months.

The commission has its hands full. It has an enormous amount of responsibility on its shoulders. Everyone pretty much knows what Congress intended. I hope the commission does the right thing, and implements that intent.

Not allowing the Postal Service to price as it wishes will kill the flexibility that the Postal Service needs to overcome the limit of the inflationary price cap. If the commission doesn’t allow the Postal Service the freedom to adapt to the new structure—and to price as it wishes—we are all in trouble.

Stay tuned. •

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