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H.R. 22, THE POSTAL REFORM ACT OF 1997

HEARING

BEFORE THE

SUBCOMMITTEE ON THE POSTAL SERVICE

OF THE

COMMITTEE ON GOVERNMENT
REFORM AND OVERSIGHT
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

ON

H.R. 22

TO REFORM THE POSTAL LAWS OF THE UNITED STATES

APRIL 16, 1997

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H.R. 22, THE POSTAL REFORM ACT OF 1997

WEDNESDAY, APRIL 16, 1997

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON THE POSTAL SERVICE,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:04 a.m., in room 2203, Rayburn House Office Building, Hon. John M. McHugh (chairman of the subcommittee) presiding.

Present: Representatives McHugh, Gilman, LaTourette, Sessions, Fattah, Owens, and Davis.

Staff present: Dan Blair, staff director; Heea Vazirani-Fales, Robert Taub, Steve Williams, and Jane Hatcherson, professional staff members; Jennifer Tracey, clerk; and Cedric Hendricks, minority professional staff member.

Mr. MCHUGH. To make it official, let me hit the gavel and call the subcommittee to order.

Welcome to all of you today. The subcommittee this morning is turning its attention to postal reform as we focus on the provisions contained in H.R. 22, the Postal Reform Act of 1997. As I am sure most of you are aware, this was introduced last year and was the subject of four extensive hearings where we heard from a broad range of postal stakeholders regarding their views and recommendations on reform measures that many, certainly that I felt were necessary to improve the Postal Service.

This morning's session will specifically focus on reforms of the current ratemaking process as envisioned in that particular bill. The current structure, as we know, was enacted 27 years ago and removed the Congress from the ratemaking process by implementing a cost basis ratemaking system, whereby rates are based on the cost of providing the specific services. H.R. 22 proposes to update this process through the initiation of a rate cap pricing regime.

I want to begin by welcoming our witnesses here today and express both my and the subcommittee's appreciation for taking the time out of your busy schedules to not just appear today but to prepare your very insightful and thoughtful testimony. I have had the opportunity to read them all. I was reminded of many things, not the least of which is why I didn't become an economics major, not because it isn't interesting, not because it isn't tremendously useful, but because I didn't have the intelligence to grasp it. I hope you gentlemen will bear that shortcoming of mine in mind as we proceed today. But again, thank you so much for joining us.

The dialog that I hope to initiate this morning, is intended to highlight any modifications that we may need to consider in evalu-

ating ratemaking reforms. H.R. 22 proposes dividing postal products into competitive and noncompetitive categories, with the later subject to rate cap regulation. I anticipate that our witnesses will comment on this proposed structure with their detailed analysis, and, I am sure, constructive recommendations.

This forum gives us the opportunity to explore in what appropriate ways a price cap should be determined, including what, if any, inflation index to use as the benchmark, and whether a factor representing productivity gains in the economy should be applied against this inflation marker. I expect that we will examine what postal products best fit in which baskets.

H.R. 22 also proposes what I feel are important new authorities on the Rate Commission, including responsibility for ensuring against service and delivery degradation. This dialog is critical in further refining our efforts to achieve a rational rate-setting process which protects captive customers from undue discrimination in rates while recognizing demand factors in pricing postal products. I hope the conversations I anticipate today will play a constructive role in our efforts to improve mail delivery and service.

In designating H.R. 22, we conspicuously attempted to draft a bill that would reflect the times conflicting demands placed on our expectations of the Postal Service. To that extent we welcome suggestions on how to best improve our efforts, and criticisms as well. I only ask that such comments be accompanied by a constructive engagement with the subcommittee.

I want to commend highly those in the profession who have chosen to offer honest dialog regarding their legitimate concerns over the potential impact postal reform could have on their respective interests. Sadly, I feel some have feigned interests to be constructive and have actually undertaken steps aimed at undermining any and all reform initiatives. I can only speculate that such behavior is grounded in one's attempts to protect pecuniary special interests or that those parties are so vested in the current process that they lack objectivity in evaluating needed reform measures.

Whatever the case, I hope all postal stakeholders can put aside past squabbles and petty rivalries and honestly assess their interest in preserving the one institution charged with providing mail service in our country. The Postal Service has a long history of fulfilling this role and our failure, in my opinion, to enact timely reforms jeopardizes both the institution and the desire to provide timely, efficient, and affordable universal mail service.

I first entered this debate with the stated intention to improve mail service to all postal customers. This goal remains paramount to me, and I know it does to the subcommittee members as well. I hope I can rely on all postal stakeholders in support of this effort.

I would like to now yield to the ranking member of the subcommittee, Mr. Fattah, for any comments he may wish to make at this time.

[The text of H.R. 22 follows:]

105TH CONGRESS
1ST SESSION

H.R. 22

TO REFORM THE POSTAL LAWS OF THE UNITED STATES.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 7, 1997

MR. MCHUGH introduced the following bill; which was referred to the Committee on Government Reform and Oversight

---

A BILL

TO REFORM THE POSTAL LAWS OF THE UNITED STATES.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Postal Reform Act of 1997".
(b) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

Sec. 1. Short title; table of contents.

TITLE I—ORGANIZATION

Sec. 101. Redesignations relating to the Governors and the Board of Governors.
Sec. 102. Redesignations relating to the Postmaster General and the Deputy Postmaster General.
Sec. 103. Clarification relating to execution of amendments.

TITLE II—GENERAL AUTHORITY

Sec. 201. Employment of postal police officers.
Sec. 202. Date of postmark to be treated as date of appeal in connection with the closing or consolidation of post offices.

TITLE III—PRESIDENTIAL POSTAL EMPLOYEE-MANAGEMENT COMMISSION

Sec. 301. Presidential Postal Employee-Management Commission.

TITLE IV—FINANCE

Sec. 401. End of Treasury control of Postal Service banking.
Sec. 402. Postal Service investments.
Sec. 403. Exclusion from Federal Financing Bank.
Sec. 404. Elimination of Treasury preemption of borrowing by the Postal Service.
Sec. 405. Elimination of Postal Service "put" on Treasury.

TITLE V—BUDGET AND APPROPRIATIONS PROCESS

Sec. 501. Repeal of provision relating to transitional appropriations.
Sec. 502. Provisions relating to benefits under chapter 81 of title 5, United States Code, for officers and employees of the former Post Office Department.
Sec. 503. Repeal of authorizations of appropriations for public service costs, revenue forgone, and certain compensatory appropriations.
Sec. 504. Congressional oversight preserved.

TITLE VI—MISCELLANEOUS PROVISIONS RELATING TO POSTAL RATES, CLASSES, AND SERVICES

Sec. 601. Change-of-address order involving a commercial mail receiving agency.
Sec. 602. Rates for mail under former section 4358.

Sec. 603. Powers of the Postal Rate Commission.
Sec. 604. Volume discounts.

TITLE VII—PROVISIONS RELATING TO THE TRANSPORTATION, CARRIAGE, OR DELIVERY OF MAIL

Sec. 701. Obsolete provisions.
Sec. 702. Expanded contracting authority.
Sec. 703. Private carriage of letters.
Sec. 704. Mailbox demonstration project.

TITLE VIII—DIRECT APPEAL OF DECISIONS OF THE MERIT SYSTEMS PROTECTION BOARD

Sec. 801. Direct appeal of decisions of the Merit Systems Protection Board.

TITLE IX—LAW ENFORCEMENT

Subtitle A—Amendments to Title 39, United States Code

Sec. 901. Make Federal assault statutes applicable to postal contract employees.
Sec. 902. Sexually oriented advertising.
Sec. 903. Allow Postal Service to retain asset forfeiture recoveries.
Sec. 904. Hazardous matter.

Subtitle B—Other Provisions

Sec. 911. Stalking Federal officers and employees.
Sec. 912. Nonmailability of controlled substances.
Sec. 913. Enhanced penalties.
Sec. 914. Postal burglary provisions.
Sec. 915. Mail, money, or other property of the United States.

TITLE X—NEW SYSTEM RELATING TO POSTAL RATES, CLASSES, AND SERVICES

Sec. 1001. Establishment.
Sec. 1002. Termination of ratemaking authority under chapter 36 and related matters.

TITLE I—ORGANIZATION

SEC. 101. REDESIGNATIONS RELATING TO THE GOVERNORS AND THE BOARD OF GOVERNORS.

(a) REFERENCES IN TITLE 39.—Title 39, United States Code, is amended—

(1) by striking "Board of Governors" each place it appears and inserting "Board of Directors";

(2) by striking "Governors" each place it appears (except wherever it appears in "Board of Governors") and inserting "Directors"; and

(3) by striking "Governor" each place it appears and inserting "Director".

(b) REFERENCES OUTSIDE TITLE 39.—Any reference in any provision of law outside title 39, United States Code, enacted before the date of the enactment of this Act—

(1) to the Board of Governors, within the meaning of section 102(2) of title 39, United States Code, as in effect before the date of the enactment of this Act, shall be treated as referring to the Board of Directors, within the meaning of such section 102(2), as amended by subsection (a); or

(2) to any of the Governors, within the meaning of section 102(3) of title 39, United States Code, as in effect before the date of the enactment of this Act, shall be treated as referring to the corresponding Director or Directors, within the meaning of such section 102(3), as amended by subsection (a).

SEC. 102. REDESIGNATIONS RELATING TO THE POSTMASTER GENERAL AND THE DEPUTY POSTMASTER GENERAL.

(a) IN GENERAL.—(1) Section 202(c) of title 39, United States Code, is amended by striking "Postmaster General" and inserting "Chief Executive Officer of the United States Postal Service".

(2) Section 202(d) of such title 39 is amended by striking "Deputy Postmaster General" and inserting "Deputy Chief Executive Officer of the United States Postal Service".

(3) Section 102 of such title 39 is amended by striking "and" at the end of paragraph (2), by striking the period at the end of paragraph (3) and inserting a semicolon, and by adding after paragraph (3) the following:

"(4) 'Chief Executive Officer', unless the context otherwise requires, means the Chief Executive Officer of the United States Postal Service appointed under section 202(c); and

"(5) 'Deputy Chief Executive Officer', unless the context otherwise requires, means the Deputy Chief Executive Officer of the United States Postal Service appointed under section 202(d).".

(b) OTHER REFERENCES IN TITLE 39.—Title 39, United States Code, is further amended—

(1) by striking "Postmaster General" each place it appears (except wherever it appears in "Deputy Postmaster General") and inserting "Chief Executive Officer"; and

(2) by striking "Deputy Postmaster General" each place it appears and inserting "Deputy Chief Executive Officer".

(c) REFERENCES OUTSIDE TITLE 39.—Any reference in any provision of law outside title 39, United States Code, enacted before the date of the enactment of this Act—

(1) to the Postmaster General shall be treated as referring to the Chief Executive Officer of the United States Postal Service; and

(2) to the Deputy Postmaster General shall be treated as referring to the Deputy Chief Executive Officer of the United States Postal Service.

SEC. 103. CLARIFICATION RELATING TO EXECUTION OF AMENDMENTS.

Any amendment made in this title to a term "each place it appears" (or other words to the same effect) shall be considered to include such term when it appears in a table of contents or a section heading.

TITLE II—GENERAL AUTHORITY

SEC. 201. EMPLOYMENT OF POSTAL POLICE OFFICERS.

Section 404 of title 39, United States Code, is amended by adding at the end the following:

"(c)(1) The Postal Service may employ guards for all buildings and areas owned or occupied by the Postal Service or under the charge and control of the Postal Service, and such guards shall have, with respect to such property, the powers of special policemen provided by the first section of the Act cited in paragraph (2), and, as to such property, the Chief Executive Officer (or his designee) may take any action that the Administrator of General Services (or his designee) may take under section 2 or 3 of such Act, attaching thereto penalties under the authority and within the limits provided in section 4 of such Act.

"(2) The Act cited in this paragraph is the Act of June 1, 1948 (62 Stat. 281), commonly known as the Protection of Public Property Act.".

SEC. 202. DATE OF POSTMARK TO BE TREATED AS DATE OF APPEAL IN CONNECTION WITH THE CLOSING OR CONSOLIDATION OF POST OFFICES.

(a) IN GENERAL.—Section 404(b) of title 39, United States Code, is amended by adding at the end the following:

"(6) For purposes of paragraph (5), any appeal received by the Commission shall—

"(A) if sent to the Commission through the mails, be considered to have been received on the date of the Postal Service postmark on the envelope or other cover in which such appeal is mailed; or

"(B) if lawfully delivered to the Commission by an enterprise in the private sector of the economy engaged in the delivery of mail, be considered to have been received on the date determined based on any appropriate documentation or other indicia (as determined under regulations of the Commission).".

(b) EFFECTIVE DATE.—This section and the amendments made by this section shall apply with respect to any determination to close or consolidate a post office which is first made available, in accordance with paragraph (3) of section 404(b) of title 39, United States Code, after the end of the 3-month period beginning on the date of the enactment of this Act.

TITLE III—PRESIDENTIAL POSTAL EMPLOYEE-MANAGEMENT COMMISSION

SEC. 301. PRESIDENTIAL POSTAL EMPLOYEE-MANAGEMENT COMMISSION.

(a) IN GENERAL.—Section 206 of title 39, United States Code, is amended to read as follows:

"§ 206. Presidential Postal Employee-Management Commission

"(a) There shall be established a Presidential Postal Employee-Management Commission (hereinafter in this section referred to as the 'Commission').

"(b)(1) The Commission shall study and make recommendations, in accordance with this section, on how employee-management relations within the Postal Service might be improved.

"(2) The Commission shall submit its recommendations—

"(A) to the President and the Congress, to the extent that they involve any legislation; and

"(B) to the Postal Service, to the extent that no legislation would be involved.

"(3) All recommendations shall be submitted in the form of a written report, with the first set of reports due within 18 months after the Commission is first constituted, and the second and third sets of reports in 12-month intervals thereafter.

"(4) The Commission shall terminate after submitting its third set of reports.

"(c)(1) The Commission shall be composed of 7 members, all of whom shall be appointed by the President. Of the members—

"(A) 2 shall be appointed from among persons who will represent the views of nonpostal labor organizations familiar with issues common to postal employees;

"(B) 2 shall be appointed from among persons who will represent the views of the management of private corporations similar in size to the Postal Service;

"(C) 2 shall be appointed from among persons well known in the fields of employee-management relations, labor mediation, and collective bargaining; and

"(D) 1 shall be appointed from among persons well known in the fields described in subparagraph (C), who are also generally viewed as not being predisposed to the interests of employees or management.

"(2) All members shall be appointed for the life of the Commission.

"(3) Not more than 4 members may be of the same political party.

"(4) Members shall serve without compensation, but shall be reimbursed for necessary travel and reasonable expenses incurred in attending meetings of the Commission.

"(5) The member appointed under paragraph (1)(D) shall serve as chairman of the Commission.

"(d)(1) The Commission shall have a Director who shall be appointed by the Commission and paid at a rate not to exceed the rate of basic pay payable for level IV of the Executive Schedule under section 5315 of title 5.

"(2) Upon request of the Commission, the Federal Mediation and Conciliation Service may detail, on a reimbursable basis, any of the personnel of that agency to the Commission to assist it in carrying out its duties under this Act.

"(3) The Commission may not appoint or retain any staff, except as provided in paragraph (1) or (2).".

(b) CLERICAL AMENDMENT.—The table of sections at the beginning of chapter 2 of title 39, United States Code, is amended by striking the item relating to section 206 and inserting the following:

"206. Presidential Postal Employee-Management Commission.".

TITLE IV—FINANCE

SEC. 401. END OF TREASURY CONTROL OF POSTAL SERVICE BANKING.

(a) IN GENERAL.—Subsection (d) of section 2003 of title 39, United States Code, is amended to read as follows:

"(d)(1) The Postal Service, in its sole discretion—

"(A) may provide that amounts which would otherwise be deposited in the revolving fund referred to in subsection (a) shall instead, to the extent considered appropriate by the Postal Service, be directly deposited in a Federal Reserve bank or a depository for public funds selected by the Postal Service; and

"(B) may provide for transfers of amounts under this subsection between or among—

"(i) Federal Reserve banks;

"(ii) depositories for public funds; and

"(iii) the revolving fund referred to in subsection (a).

"(2) The Postal Service, after consultation with the Secretary of the Treasury, shall prepare and may from time to time revise a master plan for the exercise of any authority under this subsection. Such plan shall address—

"(A) the criteria that shall be applied by the Postal Service in deciding when and how any such authority shall be exercised;

"(B) matters such as risk limitations, reserve balances, allocation or distribution of monies, liquidity requirements, and measures to safeguard against losses;

"(C) the types of notification or consultation requirements the Postal Service shall follow in connection with any exercise or proposed exercise of authority under this subsection; and

"(D) procedures under which the Postal Service shall, at least annually, render a full accounting as to how any authority under this subsection has been exercised during the period involved.

"(3)(A) Authority under this subsection may not be exercised except in accordance with applicable provisions of the master plan under paragraph (2).

"(B) The Postal Service shall submit its master plan (and any revision thereof) to the President, the Secretary of the Treasury, and each House of Congress at least 30 days before the date of its proposed implementation.".

(b) SAVINGS PROVISION.—Until the authority under section 2003(d) of title 39, United States Code, as amended by subsection (a), becomes available, the provisions of such section 2003(d), as last in effect before being so amended, shall be treated as if still in effect.

(c) STATUS OF MONIES UNCHANGED.—(1) Any amounts invested under section 2003(c) of title 39, United States Code, as amended by this title, shall be considered to be part of the Postal Service Fund, to the same extent as if they had been invested under section 2003(c) of such title 39, as last in effect before the date of the enactment of this Act.

(2) Any amounts deposited or transferred under section 2003(d) of title 39, United States Code, as amended by this title, shall be considered to be part of the Postal Service Fund, to the same extent as if they had been transferred under section 2003(d) of such title 39, as last in effect before the date of the enactment of this Act.

SEC. 402. POSTAL SERVICE INVESTMENTS.

Section 2003(c) of title 39, United States Code, is amended by striking all after "it may" and inserting the following: "invest such amounts as it considers appropriate in obligations of, or obligations guaranteed by, the Government of the United States.".

SEC. 403. EXCLUSION FROM FEDERAL FINANCING BANK.

Section 2005(d) of title 39, United States Code, is amended—

(1) in paragraph (4) by striking "and" after the semicolon;

(2) in paragraph (5) by striking the period and inserting "; and"; and

(3) by adding at the end the following:

"(6) notwithstanding the provisions of the Federal Financing Bank Act of 1973 or any other provision of law (except as may be specifically provided by reference to this paragraph in any Act enacted after this paragraph takes effect), not be eligible for purchase by, or commitment to purchase by, or sale or issuance to, the Federal Financing Bank.".

SEC. 404. ELIMINATION OF TREASURY PREEMPTION OF BORROWING BY THE POSTAL SERVICE.

Section 2006(a) of title 39, United States Code, is amended by striking all after the first sentence.

SEC. 405. ELIMINATION OF POSTAL SERVICE "PUT" ON TREASURY.

Section 2006(b) of title 39, United States Code, is amended to read as follows:

"(b) The Secretary of the Treasury may purchase obligations of the Postal Service in such amounts as the Secretary of the Treasury and the Postal Service, in their discretion, may agree.".

TITLE V—BUDGET AND APPROPRIATIONS PROCESS

SEC. 501. REPEAL OF PROVISION RELATING TO TRANSITIONAL APPROPRIATIONS.

(a) REPEAL.—(1) Section 2004 of title 39, United States Code, is repealed.

(2) The item relating to section 2004 in the table of sections at the beginning of chapter 20 of such title 39 is repealed.

(3) Section 2003(e)(2) of such title 39 is amended by striking "sections 2401 and 2004" each place it appears and inserting "section 2401".

(b) CLARIFICATION THAT LIABILITIES FORMERLY PAID PURSUANT TO SECTION 2004 REMAIN LIABILITIES PAYABLE BY THE POSTAL SERVICE.—Section 2003 of title 39, United States Code, is amended by adding at the end the following:

"(h) Liabilities of the former Post Office Department to the Employees' Compensation Fund (appropriations for which were authorized by former section 2004, as in effect before the effective date of this subsection) shall be liabilities of the Postal Service payable out of the Fund.".

(c) EFFECTIVE DATE.—This section and the amendments made by this section shall take effect on October 1, 1998.

SEC. 502. PROVISIONS RELATING TO BENEFITS UNDER CHAPTER 81 OF TITLE 5, UNITED STATES CODE, FOR OFFICERS AND EMPLOYEES OF THE FORMER POST OFFICE DEPARTMENT.

(a) IN GENERAL.—Section 8 of the Postal Reorganization Act (39 U.S.C. 1001 note) is amended by inserting "(a)" after "8." and by adding at the end the following:

"(b) For purposes of chapter 81 of title 5, United States Code, the Postal Service shall, with respect to any individual receiving benefits under such chapter as an officer or employee of the former Post Office Department, have the same authorities and responsibilities as it has with respect to an officer or employee of the Postal Service receiving such benefits.".

(b) EFFECTIVE DATE.—This section and the amendments made by this section shall take effect on October 1, 1998.

SEC. 503. REPEAL OF AUTHORIZATIONS OF APPROPRIATIONS FOR PUBLIC SERVICE COSTS, REVENUE FORGONE, AND CERTAIN COMPENSATORY APPROPRIATIONS.

(a) IN GENERAL.—Section 2401 of title 39, United States Code, is amended by striking subsections (b), (c), (d), (f), and (g), and by redesignating subsection (e) as subsection (b).

(b) CONFORMING AMENDMENTS.—(1) Section 2003 of title 39, United States Code, is amended—

(A) in subsection (e) by striking paragraph (2) and by redesignating subsection (e)(1) as subsection (e); and

(B) by striking subsection (f) and by redesignating subsection (g) as subsection (f).

(2) Section 2009 of such title 39 is amended by striking the last two sentences.

(3) Sections 2803(a) and 2804(a) of such title 39 are amended by striking "2401(g)" and inserting "2401(b)".

(4) Section 3626(a)(2)(B) of such title 39 is amended by striking "paragraph (3)(A) or section 2401(c);" and inserting "paragraph (3)(A), section 3217, or sections 3403–3406;".

(5)(A) Section 3627 of such title 39 is repealed.

(B) The item relating to section 3627 in the table of sections at the beginning of chapter 36 of such title 39 is repealed.

(C) Section 3684 of such title 39 is amended by striking "Except as provided in section 3627 of this title, no" and inserting "No".

(c) EFFECTIVE DATE.—This section and the amendments made by this section shall take effect on October 1, 1998.

SEC. 504. CONGRESSIONAL OVERSIGHT PRESERVED.

Subsection (b) of section 2401 of title 39, United States Code, as so redesignated by section 503(a), is amended—

(1) by striking "Committee on Post Office and Civil Service" each place it appears and inserting "Committee on Government Reform and Oversight";

(2) by striking "and the Committees on Appropriations of the Senate and the House of Representatives";

(3) in the matter before paragraph (1)—

(A) by striking "2009 of this title," and inserting "2009 for a fiscal year,"; and

(B) by striking "for the fiscal year for which funds are requested to be appropriated," and inserting "for such fiscal year,";

(4) in paragraph (3) by striking "during the fiscal year for which funds are requested to be appropriated," and inserting "during the fiscal year referred to in the matter before paragraph (1),";

(5) by striking "Not later than March 15 of each year," and inserting "Each year,"; and

(6) by striking "any such committee considers necessary to determine the amount of funds to be appropriated for the operation of the Postal Service," and inserting "either such committee considers necessary,".

TITLE VI—MISCELLANEOUS PROVISIONS RELATING TO POSTAL RATES, CLASSES, AND SERVICES

SEC. 601. CHANGE-OF-ADDRESS ORDER INVOLVING A COMMERCIAL MAIL RECEIVING AGENCY.

(a) IN GENERAL.—Subchapter V of chapter 36 of title 39, United States Code, is amended by adding at the end the following:

"§ 3686. Change-of-address order involving a commercial mail receiving agency

"(a) For the purpose of this section, the term 'commercial mail receiving agency' or 'CMRA' means a private business that acts as the mail receiving agent for specific clients.

"(b) Upon termination of an agency relationship between an addressee and a commercial mail receiving agency—

"(1) the addressee or, if authorized to do so, the CMRA may file a change-of-address order with the Postal Service with respect to such addressee;

"(2) a change-of-address order so filed shall, to the extent practicable, be given full force and effect; and

"(3) any mail for the addressee that is delivered to the CMRA after the filing of an appropriate order under this subsection shall be subject to subsection (c).

"(c) Mail described in subsection (b)(3) shall, if marked for forwarding and remailed by the CMRA, be forwarded by the Postal Service in the same manner as, and subject to the same terms and conditions (including limitations on the period of time for which a change-of-address order shall be given effect) as apply to, mail forwarded directly by the Postal Service to the addressee.".

(b) CLERICAL AMENDMENT.—The table of sections at the beginning of chapter 36 of title 39, United States Code, is amended by adding after the item relating to section 3685 the following:

"3686. Change-of-address order involving a commercial mail receiving agency.".

SEC. 602. RATES FOR MAIL UNDER FORMER SECTION 4358.

Section 3626 of title 39, United States Code, is amended by adding at the end the following:

"(n) In the administration of this section, matter shall not be excluded from being mailed at the rates for mail under former section 4358 solely because such matter does not meet the requirements of former section 4354(a)(5).".

SEC. 603. POWERS OF THE POSTAL RATE COMMISSION.

Section 3604 of title 39, United States Code, is amended by adding at the end the following:

"(f)(1) Any Commissioner of the Commission, any administrative law judge appointed by the Commission under section 3105 of title 5, and any employee of the Commission designated by the Commission may administer oaths, examine witnesses, take depositions, and receive evidence.

"(2) The Chairman of the Commission, any Commissioner designated by the Chairman, and any administrative law judge appointed by the Commission under section 3105 of title 5 may, with respect to any proceeding under section 3624 or 3661 or chapter 37—

"(A) issue subpenas requiring the attendance and presentation of testimony of any individual, and the production of documentary or other evidence, from any place in the United States, any territory or possession of the United States, the Commonwealth of Puerto Rico, or the District of Columbia; and

"(B) order the taking of depositions and responses to written interrogatories.

The written concurrence of a majority of the Commissioners then holding office shall, with respect to each subpena under subparagraph (A), be required in advance of its issuance.

"(3) In the case of contumacy or failure to obey a subpena issued under this subsection, upon application by the Commission, the district court of the United States for the district in which the person to whom the subpena is addressed resides or is served may issue an order requiring such person to appear at any designated

place to testify or produce documentary or other evidence. Any failure to obey the order of the court may be punished by the court as a contempt thereof.

"(g)(1) If the Postal Service determines that any document or other matter it provides to the Commission pursuant to a subpena issued under subsection (f), or otherwise at the request of the Commission in connection with any proceeding or other purpose under this chapter or chapter 37, contains information which is described in section 410(c) of this title, or exempt from public disclosure under section 552(b) of title 5, the Postal Service shall, at the time of providing such matter to the Commission, notify the Commission, in writing, of its determination (and the reasons therefor).

"(2) No officer or employee of the Commission may, with respect to any information as to which the Commission has been notified under paragraph (1)—

"(A) use such information for purposes other than the purposes for which it is supplied; or

"(B) permit anyone who is not an officer or employee of the Commission to have access to any such information.

"(3) Paragraph (2) shall not prevent information from being furnished under any process of discovery established under this title in connection with a proceeding under this chapter or chapter 37 which is conducted in accordance with sections 556 and 557 of title 5. The Commission shall, by regulations based on rule 26(c) of the Federal Rules of Civil Procedure, establish appropriate administrative and other safeguards to ensure the security and confidentiality of any information furnished under the preceding sentence.".

SEC. 604. VOLUME DISCOUNTS.

(a) IN GENERAL.—Subsection (c) of section 403 of title 39, United States Code, is amended by striking "(c)" and inserting "(c)(1)" and by adding at the end the following:

"(2) Nothing in this title shall be considered to preclude the Postal Service from offering any discount in a rate or fee, on the basis of volume, so long as—

"(A) all persons are, with respect to the class of mail or postal service involved, eligible for the same volume discount; and

"(B) the discounted rate—

"(i) if a product in the noncompetitive category of mail is involved, does not exceed the maximum rate then allowable for such product under subchapter II of chapter 37; or

"(ii) if a product in the competitive category of mail is involved, satisfies the requirement under section 3742(b) that each such product bear the direct and indirect postal costs attributable to such product plus a reasonable contribution to all other costs of the Postal Service.".

(b) DEMONSTRATION PROJECT.—

(1) IN GENERAL.—

(A) PURPOSE.—As soon as practicable after the date of the enactment of this Act, the United States Postal Service shall conduct a demonstration project, the purpose of which shall be to determine the feasibility and desirability of affording volume discounts to mailers on a negotiated basis.

(B) LIMITATION.—The demonstration project shall be limited to products in the competitive category of mail (within the meaning of section 3741(2) of title 39, United States Code, as amended by section 1001).

(C) DISCOUNTS.—Under the demonstration project, any discounts shall be on such terms and conditions as may be mutually agreed to by the Postal Service and the mailer, subject to section 403(c)(2)(B)(ii) of title 39, United States Code (as amended by subsection (a)).

(2) OTHER REQUIREMENTS.—Subsections (c)(1)(A), (d)(1) (excluding subparagraphs (A)(i), (B)(ii), and (C)(ii) thereof), and (e) of section 704 shall apply with respect to the demonstration project under this subsection.

(c) EFFECTIVE DATE.—This section and the amendments made by this section shall take effect on the date on which section 1002 (relating to termination of ratemaking authority under chapter 36 and related matters) takes effect.

TITLE VII—PROVISIONS RELATING TO TRANSPORTATION, CARRIAGE, OR DELIVERY OF MAIL

SEC. 701. OBSOLETE PROVISIONS.

(a) REPEAL.—Chapter 52 of title 39, United States Code, is repealed.

(b) CONFORMING AMENDMENTS.—(1) Section 5005(a) of title 39, United States Code, is amended—

(A) by repealing paragraph (1); and

(B) in paragraph (4) by striking "(as defined in section 5201(6) of this title)".

(2) Section 10721(b)(1) of title 49, United States Code, is amended by striking "chapters 50 and 52" and inserting "chapter 50".

(c) ELIMINATING RESTRICTION ON LENGTH OF CONTRACTS.—(1) Section 5005(b)(1) of title 39, United States Code, is amended by striking "shall be for periods not in excess of 4 years (or where the Postal Service determines that special conditions or the use of special equipment warrants, not in excess of 6 years) and".

(2) Section 5402(c) of such title 39 is amended by striking "for a period of not more than 4 years".

(3) Section 5605 of such title 39 is amended by striking "for periods of not in excess of 4 years".

SEC. 702. EXPANDED CONTRACTING AUTHORITY.

Subsection (d) of section 5402 of title 39, United States Code, is amended to read as follows:

"(d) Notwithstanding the provisions of subsections (a) through (c), the Postal Service may contract for the transportation of mail by aircraft, except as provided in subsections (f) and (g).".

SEC. 703. PRIVATE CARRIAGE OF LETTERS.

Section 601(a) of title 39, United States Code, is amended by inserting "when the amount paid for private carriage of the letter is at least $2, or" before "when".

SEC. 704. MAILBOX DEMONSTRATION PROJECT.

(a) PURPOSE.—The purpose of this section is to determine the feasibility and desirability of allowing non-postage bearing matter to be deposited in private letterboxes.

(b) PROJECT.—As soon as practicable after the date of the enactment of this Act, the United States Postal Service shall—

(1) develop a plan for the conducting of a demonstration project under this section; and

(2) within 18 months after the date of the enactment of this Act, commence implementation of such plan.

(c) SPECIFICATIONS.—

(1) IN GENERAL.—The demonstration project—

(A) shall be conducted over a 3-year period;

(B) shall include such areas as the Postal Service considers appropriate, except that such project shall include at least 1 urban area, 1 rural area, and 1 suburban area, each of which shall involve a sufficient level of participation so as to ensure meaningful results; and

(C) shall include provisions under which any person may elect not to participate, or to cease to participate, in the project.

(2) TEMPORARY SUSPENSION OF SECTION 1725 OF TITLE 18.—Section 1725 of title 18, United States Code, shall not apply with respect to conduct occurring—

(A) within an area included in the demonstration project; and

(B) while the demonstration project is ongoing.

(d) PROCEDURES.—

(1) IN GENERAL.—The Postal Service shall—

(A) develop a plan for the demonstration project which identifies—

(i) the specific areas to be included in the project;

(ii) the commencement and termination dates of the project;

(iii) the legal authority for the project; and

(iv) specific details as to what the project will entail;

(B) at least 90 days before commencing implementation of the project—

(i) publish the proposed plan in the Federal Register, including notice as to the time and manner in which interested persons may submit written comments; and

(ii) provide notification of the proposed plan to persons served within the areas to be included in the project, including the relevant information as to the time, form, and manner in which any such person shall have the opportunity to present their views, in writing or by oral presentation, as they may elect; and

(C) after considering the comments and views and any other information received under subparagraph (B), prepare the final version of the plan for such project and, not later than 30 days before commencing implementation of the project—

(i) publish the final plan in the Federal Register; and

(ii) provide notification of the final plan to persons served within the areas to be included in the project.

(2) FACTORS TO BE TAKEN INTO ACCOUNT IN SELECTING AREAS FOR INCLUSION.—In identifying areas for inclusion in the demonstration project, the Postal Service shall take into account—

(A) what types of data are needed in order to permit a meaningful evaluation under subsection (e); and

(B) such other factors as the Postal Service considers appropriate.

(3) WRITTEN DETERMINATIONS.—Any determination of the Postal Service to commence implementation of the demonstration project shall be in writing and shall include the findings of the Postal Service with respect to the factors required to be taken into account under paragraph (2). Such determination and findings shall be made available to the persons served by the Postal Service within each area included in the project.

(e) EVALUATION.—Not later than 1 year after the demonstration project ends, the Comptroller General of the United States shall submit to each House of Congress a written evaluation of such project, including recommendations as to whether or not the authority tested by the project should be broadened in scope and made permanent and, if so, with what modifications (if any).

TITLE VIII—DIRECT APPEAL OF DECISIONS OF THE MERIT SYSTEMS PROTECTION BOARD

SEC. 801. DIRECT APPEAL OF DECISIONS OF THE MERIT SYSTEMS PROTECTION BOARD.

Section 7703 of title 5, United States Code, is amended by adding at the end the following:

"(e)(1) The Chief Executive Officer may, with respect to any employee of the Postal Service or applicant for employment with the Postal Service, and subject to the provisions of sections 409(b)–(e) and 411 of title 39, obtain review of any final order or decision of the Board by filing a petition for judicial review in the United States Court of Appeals for the Federal Circuit if the Chief Executive Officer determines, in his or her discretion, that the Board erred in interpreting a civil service law, rule, or regulation affecting personnel management and that the Board's decision will have a substantial impact on a civil service law, rule, regulation, or policy directive, as applied with respect to the Postal Service. If the Chief Executive Officer did not intervene in a matter before the Board, the Chief Executive Officer may not petition for review of a Board decision under this section unless the Chief Executive Officer first petitions the Board for a reconsideration of its decision, and such petition is denied. In addition to the named respondent, the Board and all other parties to the proceedings before the Board shall have the right to appear in the proceeding before the Court of Appeals. The granting of the petition for judicial review shall be at the discretion of the Court of Appeals.

"(2) For purposes of applying the provisions of section 7701(e) in the case of a decision that relates to an employee of the Postal Service or applicant for employment with the Postal Service, such provisions shall be applied by substituting 'Director or Chief Executive Officer of the United States Postal Service' for 'Director'.

"(3) For purposes of this subsection—

"(A) the term 'Chief Executive Officer' means the Chief Executive Officer of the United States Postal Service; and

"(B) the term 'Postal Service' means the United States Postal Service.".

TITLE IX—LAW ENFORCEMENT

Subtitle A—Amendments to Title 39, United States Code

SEC. 901. MAKE FEDERAL ASSAULT STATUTES APPLICABLE TO POSTAL CONTRACT EMPLOYEES.

Section 1008 of title 39, United States Code, is amended—

(1) in subsection (a) by inserting "or entrusted with mail under contract with the Postal Service" after "mail"; and

(2) in subsection (b) by inserting "an employee of the Postal Service for the purposes of sections 111 and 1114 of title 18, and" after "deemed".

SEC. 902. SEXUALLY ORIENTED ADVERTISING.

(a) CIVIL PENALTY.—Section 3011 of title 39, United States Code, is amended—

(1) by redesignating subsections (b) through (e) as subsections (c) through (f), respectively; and

(2) by inserting after subsection (a) the following:

"(b)(1) Upon a finding by the court that a sexually oriented advertisement has been mailed in violation of section 3010(b), the court may assess, on whoever made the mailing or caused it to be made, a civil penalty of not less than $500 and not

more than $1,500 for each violation. Each piece of mail sent in violation of section 3010(b) shall constitute a separate violation.

"(2) For purposes of this subsection—

"(A) receipt of a sexually oriented advertisement after the recipient's name and address have been listed (as described in section 3010(b)) for at least 60 days shall create a rebuttable presumption that such advertisement was mailed more than 30 days after that individual's name and address became so listed; and

"(B) receipt in the mail of a sexually oriented advertisement addressed to 'Occupant' or 'Resident' (or any other term permitted by Postal Service standards on simplified addressing) at the recipient's address, or which is specifically addressed to the recipient, but with an inconsequential error or variation in the recipient's name or address, shall, for purposes of applying the mailing prohibition of section 3010(b), create a rebuttable presumption that such advertisement was mailed to such recipient.

"(3) Any penalty assessed under paragraph (1) shall be paid to the Postal Service for deposit in the Postal Service Fund established by section 2003.".

(b) REPEAL.—

(1) IN GENERAL.—Section 3008 of title 39, United States Code, and the item relating to such section in the table of sections at the beginning of chapter 30 of such title, are repealed.

(2) CONFORMING AMENDMENTS.—(A) Subsection (f) of section 3011 of such title 39 (as so redesignated by subsection (a)) is amended by striking "section 3006, 3007, or 3008" and inserting "section 3006 or 3007".

(B) Section 1737 of title 18, United States Code, is amended—

(i) in subsection (a) by striking "3008 or"; and

(ii) in subsection (b) by striking "3008(a) or".

(c) EFFECTIVE DATE.—This section and the amendments made by this section shall take effect 90 days after the date of the enactment of this Act. The amendments made by this section shall be treated as if they had never been enacted for purposes of any mailing made or caused to be made before this section takes effect.

SEC. 903. ALLOW POSTAL SERVICE TO RETAIN ASSET FORFEITURE RECOVERIES.

Paragraph (7) of section 2003(b) of title 39, United States Code, is amended to read as follows:

"(7) amounts (including proceeds from the sale of forfeited items) from any civil forfeiture conducted by the Postal Service and from any forfeiture resulting from an investigation in which the Postal Service has primary responsibility, except that nothing in this paragraph shall preclude the Postal Service, on such terms as it may determine, from sharing such amounts with any Federal, State, or local law enforcement agency which participated in any of the acts which led to the seizure or forfeiture of the property; and".

SEC. 904. HAZARDOUS MATTER.

(a) CIVIL PENALTY.—Chapter 30 of title 39, United States Code, is amended by adding at the end the following:

"§ 3016. Civil penalty for prohibited mailing and deficient packaging of hazardous matter

"(a) For the purposes of this section—

"(1) the term 'parcel' includes any kind of package, envelope, container, or other piece of mail;

"(2) the term 'manner' includes the preparation and packaging of a piece of mail;

"(3) a person shall be considered to have acted knowingly if—

"(A) such person had actual knowledge of the facts giving rise to the violation; or

"(B) a reasonable person acting in the same circumstances and exercising due care would have had such knowledge; and

"(4) the term 'hazardous matter' has the meaning given such term by section 1716 of title 18.

"(b) Any person—

"(1) who knowingly mails or causes to be mailed any parcel, the contents of which constitute or include any hazardous matter which has been declared by statute or Postal Service regulation to be nonmailable under any circumstances;

"(2) who knowingly mails or causes to be mailed a parcel in violation of any statute or Postal Service regulation restricting the time, place, or manner in which hazardous matter may be mailed; or

"(3) who knowingly manufactures, distributes, or sells any container, packaging kit, or similar device that—

"(A) is represented, marked, certified, or sold by such person for use in the mailing of any hazardous matter; and

"(B) fails to conform with any statute or Postal Service regulation setting forth standards for containers, packaging kits, or similar devices used for the mailing of hazardous matter;

shall be liable to the Postal Service for a civil penalty in an amount not to exceed $25,000 per violation.

"(c) The Postal Service may enforce this section by commencing a civil action in accordance with section 409(d). The action may be brought in the district court of the United States for the district in which the defendant resides or any district in which the defendant conducts business or in which a violation of this section was discovered.

"(d) In determining the amount of any civil penalty to be assessed under this section, the district court—

"(1) shall treat as a separate violation—

"(A) each parcel mailed or caused to be mailed as described in paragraph (1) or (2) of subsection (b); and

"(B) each container, packaging kit, or similar device manufactured, distributed, or sold as described in subsection (b)(3); and

"(2) shall take into account—

"(A) the nature, circumstances, extent, and gravity of each violation committed; and

"(B) with respect to the person found to have committed such violation, the degree of culpability, any history of prior offenses, ability to pay, effect on ability to continue to do business, and such other matters as justice may require.

"(e) All penalties collected under authority of this section shall be paid into the Postal Service Fund established by section 2003.".

(b) CLERICAL AMENDMENT.—The table of sections at the beginning of chapter 30 of title 39, United States Code, is amended by adding at the end the following:

"3016. Civil penalty for prohibited mailing and deficient packaging of hazardous matter.".

Subtitle B—Other Provisions

SEC. 911. STALKING FEDERAL OFFICERS AND EMPLOYEES.

(a) IN GENERAL.—Chapter 41 of title 18, United States Code, is amended by adding at the end the following:

"§ 881. Stalking Federal and postal officers and employees

"(a) Whoever—

"(1) repeatedly engages in a pattern of conduct (including maintaining a visual or physical proximity or verbal or written threat) directed at another person who is or was an officer or employee—

"(A) in the executive, legislative, or judicial branch of the Federal Government; or

"(B) in the United States Postal Service;

while such other person is engaged in official duties or on account of such duties;

"(2) knows that such conduct is likely to place that other person in reasonable fear of sexual battery, bodily injury, or death; and

"(3) thereby induces such fear in that other person;

shall be punished as provided in subsection (b) of this section.

"(b)(1) The punishment for an offense under subsection (a) of this section is the greatest of the following:

"(A) In the case of a first conviction under such subsection, a fine under this title or imprisonment for not more than 3 years, or both.

"(B) In the case of a second or subsequent conviction under such subsection, a fine under this title or imprisonment for not more than 15 years, or both.

"(C) If, during the commission of the offense, the offender uses a deadly or dangerous weapon, a fine under this title or imprisonment for not more than 10 years, or both.

"(D) If the offense violates a protective order, a fine under this title or imprisonment for not more than 5 years, or both.

"(2) If a sentence of probation is imposed for an offense under subsection (a) of this section, the court shall require the defendant to undergo appropriate psychiatric, psychological, or social counselling.

"(c) As used in this section, the term 'protective order' means any court order that requires an individual—

"(1) to refrain from behavior prohibited by subsection (a) of this section; or

"(2) to refrain from contact with the person who subsequently is a victim of the offense under such subsection that is committed by that individual.

"(d)(1) Whoever is or is about to be aggrieved by a violation of subsection (a) of this section may, in a civil action, obtain from the person engaging or about to engage in that violation, appropriate relief, including punitive damages in the case of a completed violation and reasonable attorney's fees.

"(2) If—

"(A) the court issues an injunction against the person engaging or about to engage in a violation of subsection (a) of this section;

"(B) such person is an officer or employee in the executive branch of the Federal Government or in the United States Postal Service; and

"(C) there is a nexus between the enjoined conduct and such person's office or employment;

the court may order that the person be suspended or summarily discharged from such office or employment.".

(b) CLERICAL AMENDMENT.—The table of sections at the beginning of chapter 41 of title 18, United States Code, is amended by adding at the end the following:

"881. Stalking Federal and postal officers and employees.".

SEC. 912. NONMAILABILITY OF CONTROLLED SUBSTANCES.

Section 1716 of title 18, United States Code, is amended by adding at the end the following:

"Whoever knowingly deposits for mailing or delivery, or knowingly causes to be delivered by mail, according to the direction thereon, or at any place at which it is directed to be delivered by the person to whom it is addressed, unless in accordance with the rules and regulations authorized to be prescribed by the Postal Service, any controlled substance, as that term is defined for the purposes of the Controlled Substances Act, shall, if the distribution of a like amount of such substance is a felony under such Act, be fined under this title or imprisoned not more than 5 years, or both.".

SEC. 913. ENHANCED PENALTIES.

Pursuant to its authority under section 994 of title 28, United States Code, the United States Sentencing Commission shall amend its sentencing guidelines to—

(1) appropriately enhance penalties in cases in which a defendant is convicted of stealing or destroying a quantity of undelivered United States mail, in violation of sections 1702, 1703, 1708, 1709, 2114, or 2115 of title 18, United States Code; and

(2) establish that the intended loss in a theft of an access device as defined in section 1029(e)(1) of title 18, United States Code, shall be based on the credit line of the access device or the actual unauthorized charges, whichever amount is greater.

SEC. 914. POSTAL BURGLARY PROVISIONS.

(a) LARCENY INVOLVING POST OFFICE BOXES AND POSTAL STAMP VENDING MACHINES.—Section 2115 of title 18, United States Code, is amended—

(1) by striking "or" before "any building";

(2) by inserting "or any post office box or postal products vending machine," after "used in whole or in part as a post office,";

(3) by inserting "or in such box or machine," after "so used"; and

(4) by striking "not more than $1,000" and inserting "under this title".

(b) RECEIPT, POSSESSION, CONCEALMENT, OR DISPOSITION OF PROPERTY.—Section 2115 of title 18, United States Code, is amended—

(1) by inserting "(a)" before "Whoever"; and

(2) by adding at the end the following:

"(b) Whoever receives, possesses, conceals, or disposes of any mail matter, money, or other property of the United States, that has been obtained in violation of this section, knowing the same to have been unlawfully obtained, shall be fined under this title or imprisoned not more than 5 years, or both.".

SEC. 915. MAIL, MONEY, OR OTHER PROPERTY OF THE UNITED STATES.

(a) ENHANCED PENALTY FOR ROBBERY.—Subsection (a) of section 2114 of title 18, United States Code, is amended to read as follows:

"(a) ASSAULT.—Whoever assaults any person having lawful charge, control, or custody of any mail matter or of any money or other property of the United States, with intent to rob, steal, or purloin such mail matter, money, or other property of the United States, or robs or attempts to rob any such person of mail matter, or of any money, or other property of the United States, shall, for the first offense, be imprisoned not more than 10 years or fined under this title, or both. If, in effecting or attempting to effect such robbery the defendant wounds the person having custody of such mail, money, or other property of the United States, or puts that person's life in jeopardy by the use of a dangerous weapon, or the offense is a subsequent offense under this subsection, the defendant shall be imprisoned not more than 25 years or fined under this title, or both. If the death of any person results from the offense under this subsection, the defendant shall be punished by death or life imprisonment.".

(b) ATTEMPT OFFENSES.—

(1) The second paragraph of section 501 of title 18, United States Code, is amended by striking "uses or sells," and inserting "uses or sells or attempts to use or sell,".

(2) Section 1711 of title 18, United States Code, is amended by inserting "attempts to loan, use, pledge, hypothecate, or convert to this own use," after "converts to his own use,".

TITLE X—NEW SYSTEM RELATING TO POSTAL RATES, CLASSES, AND SERVICES

SEC. 1001. ESTABLISHMENT.

(a) IN GENERAL.—Title 39, United States Code, is amended by adding after chapter 36 the following:

"CHAPTER 37—NEW SYSTEM FOR ESTABLISHING POSTAL RATES, CLASSES, AND SERVICES

"SUBCHAPTER I—BASELINE RATES AND FEES

"Sec.
"3701. Establishment of baseline rates and fees.

"SUBCHAPTER II—RATES AND FEES FOR PRODUCTS IN THE NONCOMPETITIVE CATEGORY OF MAIL

"3721. Definitions.
"3722. Maximum rates.
"3723. Adjustment factor.
"3724. Action of the Directors.

"SUBCHAPTER III—RATES AND FEES FOR PRODUCTS IN THE COMPETITIVE CATEGORY OF MAIL

"3741. Definitions.
"3742. Action of the Directors.
"3743. Transfers of products from the noncompetitive category of mail.
"3744. Application of antitrust laws.

"SUBCHAPTER IV—MARKET TESTS OF EXPERIMENTAL PRODUCTS

"3761. Market tests.

"SUBCHAPTER V—REPORTING REQUIREMENTS AND RELATED PROVISIONS

"3781. Definition.
"3782. Reporting requirements.
"3783. Use of profits.

"SUBCHAPTER I—BASELINE RATES AND FEES

"§ 3701. Establishment of baseline rates and fees

"(a) REQUIREMENT THAT A RATEMAKING REQUEST BE MADE.—

"(1) IN GENERAL.—Except as provided in paragraph (2), the Postal Service shall, within 18 months after the effective date of this chapter, request the Postal Rate Commission to submit a recommended decision on appropriate changes in rates of postage and in fees for postal services, in accordance with section 3622(a).

"(2) EXCEPTION.—A request under this subsection may not be made if, on the effective date of this chapter—

"(A) a new schedule of rates and fees takes effect under subchapter II of chapter 36 pursuant to a previous request under section 3622(a); or

"(B) a recommended decision or further recommended decision pursuant to a previous request under section 3622(a), or judicial review of any such decision or recommended decision, is pending.

"(b) BASELINE RATES AND FEES ESTABLISHED PURSUANT TO THIS SECTION.—

"(1) IN GENERAL.—For purposes of this title, the baseline rates and fees established pursuant to this section shall be—

"(A) the rates and fees taking effect pursuant to a request made under subsection (a)(1), subject to subparagraph (C)(i) or paragraph (2)(A) (as applicable);

"(B) the rates and fees—

"(i) that, by virtue of subsection (a)(2)(A), preclude the making of a request under subsection (a)(1); or

"(ii) that take effect upon completion of all proceedings referred to in subsection (a)(2)(B), subject to subparagraph (C)(ii) or paragraph (2)(B) (as applicable); or

"(C)(i) if a request under subsection (a)(1) is made, but proceedings pursuant to such request have not been completed by the end of the 18-month period beginning on the date on which such request is made, the rates and fees in effect at the end of such period (including any temporary rate or fee then in effect under subchapter III of chapter 36); or

"(ii) if a request under subsection (a)(1) is precluded by virtue of the provisions of subsection (a)(2)(B), but the proceedings referred to in such provisions have not been completed by the end of the 18-month period referred to in subsection (a)(1), the rates and fees in effect at the end of such period (including any temporary rate or fee then in effect under subchapter III of chapter 36).

"(2) APPLICABLE STATUTORY DEADLINE NOT CHANGEABLE BY ADMINISTRATIVE OR OTHER ACTION.—Rates and fees established under chapter 36 pursuant to—

"(A) a request made under subsection (a)(1) shall take effect as of the date determined in accordance with section 3625(f) or otherwise applicable provisions of such chapter, except that in no event may the date so determined be later than the last day of the 18-month period referred to in paragraph (1)(C)(i); or

"(B) a previous request, as referred to in subsection (a)(2)(B), shall take effect as of the date determined in accordance with section 3625(f) or otherwise applicable provisions of such chapter, except that in no event may the date so determined be later than the last day of the 18-month period referred to in subsection (a)(1).

"(c) PRIORITY OF RATEMAKING FACTORS IF PURSUANT TO A REQUEST UNDER THIS SECTION.—If a request under subsection (a)(1) is made, then, for purposes of all proceedings under chapter 36 relating to such request, subsection (b) of section 3622 shall be considered to be amended to read as follows:

"'(b) Upon receiving a request, the Commission shall make a recommended decision on the request for changes in rates or fees in each class of mail or type of service in accordance with the policies of this title and the following factors, set forth in descending order of priority:

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

"'(2) The value of the mail service to senders, as reflected by the volume response of classes of mail and types of service to changes in postal rates and fees, and, as appropriate, the price and quality of alternative means of sending mail.

"'(3) The quality of mail service actually provided each class or type of mail service, including the collection, mode of transportation, priority of delivery, and timeliness of delivery (as measured by reference to standards established by the Postal Service).

"'(4) The available alternative means of sending and receiving letters and other mail matter at reasonable costs.

"'(5) 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.

"'(6) The effect of rate increases upon users of the mail and the general public.

"'(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) The establishment and maintenance of a fair and equitable schedule.

"'(10) Such other factors as the Commission deems appropriate.'.

"SUBCHAPTER II—RATES AND FEES FOR PRODUCTS IN THE NONCOMPETITIVE CATEGORY OF MAIL

"§ 3721. Definitions

"For purposes of this subchapter—

"(1) YEAR.—The term 'year' means a calendar year.

"(2) GDPPI.—The term 'GDPPI' means the Gross Domestic Product Chain-Type Price Index (published quarterly by the Bureau of Economic Analysis of the Department of Commerce).

"(3) PRODUCT.—The term 'product' means a class of mail or type of postal service, including—

"(A) a subclass or other similar subordinate unit thereof; and

"(B) any further subordinate unit thereof (below the first level of subordinate units referred to in subparagraph (A)).

"(4) PRODUCTS IN THE NONCOMPETITIVE CATEGORY OF MAIL.—The term 'products in the noncompetitive category of mail' means the respective products in the first, second, third, and fourth baskets of products (within the meaning of section 3723(a)).

"(5) RATE.—The term 'rate', used with respect to a product, means—

"(A) for a class of mail, the rate for such class of mail; and

"(B) for a type of postal service, the fee for such service.

"(6) NONCOMPETITIVE PRODUCT.—The term 'noncompetitive product' means a product in the noncompetitive category of mail.

"§ 3722. Maximum rates

"(a) IN GENERAL.—Except as otherwise provided in this subchapter, the rate for a noncompetitive product may not, in any year, exceed the maximum rate allowable for such product in such year under this section.

"(b) COMPUTATION OF MAXIMUM RATE ALLOWABLE.—

"(1) IN GENERAL.—The maximum rate allowable for a noncompetitive product in any year shall be computed by multiplying—

"(A) the change in the GDPPI for such year, adjusted by the adjustment factor for such year, times

"(B) the maximum rate allowable for such product in the preceding year (determined disregarding paragraph (4), any exercise of authority under section 3724(d), and any alternative limitation under section 1002(e) of the Postal Reform Act of 1997).

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) CHANGE IN THE GDPPI.—The change in the GDPPI for any year shall be equal to the percentage (if any) by which—

"(i) the GDPPI for the preceding year, exceeds

"(ii) the GDPPI for the second preceding year.

"(B) GDPPI FOR ANY YEAR.—The GDPPI for any year is the average of the GDPPI for the 4 consecutive calendar quarters ending on September 30th of such year.

"(C) ADJUSTMENT FACTOR.—The adjustment factor for any year shall be determined in accordance with section 3723.

"(3) SPECIAL RULE FOR FIRST COMPUTATION.—For purposes of the first computation of a maximum rate allowable under this section for any product, the rate applied under paragraph (1)(B) shall be the baseline rate established for such product under section 3701.

"(4) ROUNDING.—Any maximum rate computed under this section shall be rounded to the nearest cent (rounding ½ of a cent to the next higher cent).

"§ 3723. Adjustment factor

"(a) DEFINITIONS.—For purposes of this section—

"(1) RATEMAKING CYCLE.—

"(A) IN GENERAL.—The term 'ratemaking cycle' means—

"(i) the 5-year period beginning on the first day of the second year beginning after the effective date of the baseline rates and fees established pursuant to section 3701; and

"(ii) each 5-year period beginning on the day after the last day of the immediately preceding 5-year period under this paragraph.

"(B) EARLIER INITIAL DATE.—The Postal Rate Commission may, by written determination, advance the date applicable under subparagraph (A)(i) to the date which occurs 1 year earlier, but only if that earlier date does not precede the date on which all requirements of this section have been completed with respect to the ratemaking cycle involved.

"(2) BASKET OF PRODUCTS TO WHICH THIS SECTION APPLIES.—The term 'basket of products to which this section applies' means the first, second, third, and fourth baskets of products.

"(3) FIRST BASKET OF PRODUCTS.—The term 'first basket of products' means—

"(A) single-piece first-class letters (both domestic and international);

"(B) single-piece first-class cards (both domestic and international); and

"(C) single-piece first-class parcels (both domestic and international).

"(4) SECOND BASKET OF PRODUCTS.—The term 'second basket of products' means all first-class mail not in the first basket of products.

"(5) THIRD BASKET OF PRODUCTS.—The term 'third basket of products' means periodicals.

"(6) FOURTH BASKET OF PRODUCTS.—The term 'fourth basket of products' means standard mail (except for parcel post).

"(7) RULE OF CONSTRUCTION.—

"(A) IN GENERAL.—Mail matter referred to in paragraphs (3) through (6) shall, for purposes of such paragraphs, be considered to have the meaning given them under the mail classification schedule (within the meaning of section 3623) as of the effective date of this chapter.

"(B) UPDATES.—The Board of Directors shall, whenever any relevant change occurs (pursuant to a reclassification under chapter 36, a transfer of a product from the noncompetitive category of mail under section 3743, or the conversion of an experimental product under subchapter IV to a permanent one), prescribe new lists of products within the baskets under paragraphs (3) through (6), respectively. The revised lists shall indicate how and when any previous lists are superseded.

"(b) PROCEDURES RELATING TO DETERMINING ADJUSTMENT FACTORS.—

"(1) COMMENCEMENT.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the Postal Rate Commission shall, beginning in December of the second year before the start of each ratemaking cycle, provide the opportunity for a hearing on the record under sections 556 and 557 of title 5 to the Postal Service, users of the mails, and an officer of the Commission who shall be required to represent the interests of the general public, with respect to the adjustment factors to be established for the upcoming ratemaking cycle.

"(B) EXCEPTION.—For purposes of the first hearing under this subsection, proceedings shall be commenced during the second month beginning on or after the effective date of the baseline rates and fees established pursuant to section 3701.

"(2) RULES OF PROCEEDINGS.—In order to conduct its proceedings with utmost expedition consistent with procedural fairness to the parties, the Commission may (without limitation) adopt rules which provide for—

"(A) the advance submission of written direct testimony;

"(B) the conduct of prehearing conferences to define issues, and for other purposes to insure orderly and expeditious proceedings;

"(C) discovery both from the Postal Service and the parties to the proceedings;

"(D) limitation of testimony; and

"(E) the conduct of the entire proceedings off the record with the consent of the parties.

"(3) PRINTING AND NOTICE REQUIREMENTS.—

"(A) IN GENERAL.—The Commission's decision and the record of the Commission's hearings shall be made generally available at the time the

decision is issued and shall be printed and made available for sale by the Public Printer within 10 days following the day the decision is issued.

"(B) TIMING.—All actions required of the Commission under this section, including those under subparagraph (A), shall be completed as expeditiously as possible, but in no event later than the end of the year before the commencement of the ratemaking cycle to which the decision relates.

"(c) FACTORS.—Adjustment factors shall be established in accordance with the policies of this title and the following:

"(1) The value of the product to senders, as reflected by the volume response of classes of mail and types of service to changes in postal rates and fees, and, as appropriate, the price and quality of alternative means of sending mail.

"(2) Cost to the Postal Service of providing the product.

"(3) Productivity of the Postal Service in providing postal services.

"(4) The level of postal revenues attributable to the product.

"(5) The actual level of service (described in terms of speed of delivery and reliability) provided with respect to the product.

"(6) Such other considerations as the Postal Service and the Commission mutually agree to be appropriate.

"(d) SEPARATE ADJUSTMENT FACTOR REQUIRED FOR EACH BASKET OF PRODUCTS.—A separate adjustment factor shall be established for each basket of products to which this section applies, and, except as provided in section 3724(d), the adjustment factor applicable to any basket shall be uniformly applied to all products within such basket.

"(e) HOW EACH ADJUSTMENT FACTOR IS TO BE EXPRESSED AND APPLIED.—

"(1) EXPRESSION.—Each adjustment factor established under this section shall be expressed as a percentage.

"(2) APPLICATION.—For purposes of section 3722(b)(1)(A), to adjust a change in the GDPPI by an adjustment factor, the adjustment factor shall be added to or subtracted from such change in the GDPPI, as the case may be.

"(f) EXIGENT CIRCUMSTANCES.—

"(1) IN GENERAL.—Upon a majority vote of the Directors then holding office, the Postal Service may request the Postal Rate Commission to render a decision on changing the adjustment factors to be applied during the then current ratemaking cycle (after having previously been established under this section for such cycle).

"(2) CONDITIONS.—A request made under paragraph (1) may be considered only upon written certification by the Directors that—

"(A) the Postal Service faces severe financial exigencies; and

"(B) the change is warranted to restore the Postal Service to fiscal soundness.

"(3) EFFECT; DURATION.—A change granted under this subsection—

"(A) shall supersede the adjustment factors which would otherwise apply under this section; and

"(B) shall remain effective for the remainder of the ratemaking cycle involved, subject to paragraph (5).

"(4) EXPEDITED CONSIDERATION.—A request made under paragraph (1) shall be acted on in the same manner as if initiated under subsection (b)(1), except that a decision on such request shall be rendered not later than 6 months after the date on which such request is made.

"(5) FREQUENCY.—Nothing in this section shall be considered to limit the number of times that authority under this subsection may be invoked or exercised during any particular ratemaking cycle.

"(6) FINALITY.—A decision of the Postal Rate Commission under this subsection shall be final and shall not be subject to administrative or judicial review.

"(g) APPELLATE REVIEW.—Except as provided in subsection (f)(6), a decision of the Postal Rate Commission under this section may be appealed to any court of appeals of the United States, within 15 days after its publication by the Public Printer, by an aggrieved party who appeared in the proceedings under subsection (b). The court shall review the decision, in accordance with section 706 of title 5, and chapter 158 and section 2112 of title 28, except as otherwise provided in this subsection, on the basis of the record before the Commission. The court may affirm the decision or order that the entire matter be returned for further consideration, but the court may not modify the decision. The court may not suspend the effectiveness of the adjustment factors, or otherwise prevent them from taking effect until final disposition of the suit by the court. No court shall have jurisdiction to review a decision made by the Commission under this section except as provided in this subsection.

"§ 3724. Action of the Directors

"(a) IN GENERAL.—The Directors, with the written concurrence of a majority of all of the Directors then holding office, shall establish rates for products in the noncompetitive category of mail in accordance with the requirements of this subchapter and the policies of this title.

"(b) PROCEDURES.—

"(1) IN GENERAL.—Rates under this section shall be established in writing, complete with a statement of explanation and justification.

"(2) PUBLICATION.—The Directors shall cause each such decision and statement to be published in the Federal Register at least 45 days before the rate or rates to which they pertain take effect.

"(c) LIMITATIONS ON AUTHORITY.—

"(1) IN GENERAL.—Except as provided in paragraph (2)—

"(A) FREQUENCY.—Ratemaking authority under this section may not be exercised more than once for purposes of any year.

"(B) UNIFORM EFFECTIVE DATE.—All changes in rates pursuant to this section shall take effect beginning on the same date.

"(2) EXCEPTION FOR CHANGE DUE TO EXIGENT CIRCUMSTANCES.—

"(A) IN GENERAL.—If the maximum rate allowable for a product in a year changes pursuant to a request granted under section 3723(f), then, in the event that ratemaking authority under this section was previously exercised with respect to such product for such year, such rate may be modified, not more than once more in such year, based on the change in the maximum rate allowable.

"(B) UNIFORM EFFECTIVE DATE.—All changes in rates pursuant to this paragraph shall, to the extent based on the same change in the maximum rate allowable, take effect beginning on the same date.

"(d) EXCEPTION TO REQUIREMENT RELATING TO UNIFORM APPLICABILITY OF EACH MAXIMUM.—

"(1) DEFINITIONS.—For purposes of this subsection—

"(A) SUBORDINATE UNIT.—The term 'subordinate unit', with respect to a product, means a subclass or other similar subordinate unit of such product, as described in subparagraph (A) of section 3721(3).

"(B) FURTHER SUBORDINATE UNIT.—The term 'further subordinate unit', with respect to a subordinate unit, means a further subordinate unit thereof, as described in subparagraph (B) of section 3721(3).

"(2) APPLICABILITY.—This subsection applies with respect to the second, third, and fourth baskets of products.

"(3) RULE.—

"(A) IN GENERAL.—Notwithstanding the uniformity requirement in section 3723(d), for purposes of establishing rates for further subordinate units of any particular subordinate unit of a product, rates may be established at such levels as the Directors consider appropriate, subject to subparagraph (B).

"(B) REQUIREMENT.—The rates so established may not exceed the maximum rates established for such further subordinate units in accordance with subparagraph (C).

"(C) ALTERNATIVE MAXIMUM RATES.—Alternative maximum rates may be established under this subparagraph by using adjustment factors (other than those that would otherwise apply absent this subsection) fixed at levels which the Directors consider appropriate, so long as the resulting average maximum rate, for the further subordinate units comprising such subordinate unit (determined separately for each successive level, if there are 2 or more levels of further subordinate units), remains equal to the maximum rate that would otherwise apply with respect to those further subordinate units.

"(e) FINALITY OF DECISIONS.—Decisions of the Postal Service under this section shall be final and shall not be subject to administrative or judicial review.

"SUBCHAPTER III—RATES AND FEES FOR PRODUCTS IN THE COMPETITIVE CATEGORY OF MAIL

"§ 3741. Definitions

"For purposes of this subchapter—

"(1) YEAR, PRODUCT, RATE, ETC.—The terms 'year', 'product', 'rate', and 'product in the noncompetitive category of mail' each has the meaning given such term by section 3721, unless the context otherwise requires.

"(2) PRODUCTS IN THE COMPETITIVE CATEGORY OF MAIL.—The term 'products in the competitive category of mail' means—

"(A) priority mail;

"(B) expedited mail;

"(C) mailgrams;

"(D) international mail;

"(E) parcel post;

"(F) special services; and

"(G) any product transferred to the competitive category of mail under section 3743;

except that such term does not include any product then currently in the noncompetitive category of mail.

"(3) RULE OF CONSTRUCTION.—

"(A) IN GENERAL.—Mail matter referred to in paragraph (2) shall, for purposes of such paragraph, be considered to have the meaning given them under the mail classification schedule (within the meaning of section 3623) as of the effective date of this chapter.

"(B) UPDATES.—The Board of Directors shall, whenever any relevant change occurs (pursuant to a reclassification under chapter 36, a transfer of a product from the noncompetitive category of mail under section 3743, or the conversion of an experimental product under subchapter IV to a permanent one), prescribe a new list of products under subparagraphs (A) through (G) of paragraph (2). The revised list shall indicate how and when any previous list is superseded.

"§ 3742. Action of the Directors

"(a) IN GENERAL.—The Directors, with the written concurrence of a majority of all of the Directors then holding office, shall establish rates for products in the competitive category of mail.

"(b) REQUIREMENTS.—Rates under this section shall be established in accordance with the policies of this title and the requirement that each product in the competitive category of mail bear the direct and indirect postal costs attributable to such product plus a reasonable contribution to all other costs of the Postal Service.

"(c) PROCEDURES.—Subsections (b), (c)(1), and (e) of section 3724 shall apply with respect to rates and decisions under this section.

"§ 3743. Transfers of products from the noncompetitive category of mail

"(a) IN GENERAL.—The Postal Service or users of the mails may from time to time request the Postal Rate Commission to submit, or the Commission may submit to the Directors on its own initiative, a recommended decision on transferring one or more products in the noncompetitive category of mail to the competitive category of mail.

"(b) CRITERIA.—A recommended decision under this section shall be made in accordance with the policies of this title and taking into consideration the availability and nature of enterprises in the private sector engaged in the delivery of the product involved.

"(c) PROCEDURES.—If the Commission receives a request under subsection (a) or decides to act on its own initiative, the Commission shall, after proceedings in conformity with section 3624, issue a recommended decision which shall be acted upon in accordance with the provisions of section 3625 and subject to review in accordance with the provisions of section 3628.

"§ 3744. Application of antitrust laws

"(a) APPLICABILITY OF THE ANTITRUST LAWS.—The antitrust laws shall apply with respect to the Postal Service to the extent that the Postal Service engages in conduct with respect to—

"(1) any product in the competitive category of mail; and

"(2) any product offered pursuant to a market test under subchapter IV.

"(b) DEFINITION.—For purposes of subsection (a), the term 'antitrust laws' has the meaning given such term in subsection (a) of the first section of the Clayton Act (15 U.S.C. 12(a)), but includes section 5 of the Federal Trade Commission Act (15 U.S.C. 45) to the extent that such section 5 applies to unfair methods of competition.

"(c) EFFECTIVE DATE.—This section shall not apply with respect to conduct occurring before the effective date of this chapter.

"SUBCHAPTER IV—MARKET TESTS OF EXPERIMENTAL PRODUCTS

"§ 3761. Market tests

"(a) IN GENERAL.—The Postal Service may conduct market tests of experimental products. Subject to the provisions of this section, the conducting of any such market test by the Postal Service shall not be limited by any lack of specific authority under this title to take the action contemplated, or by any provision of this title or any rule or regulation prescribed under this title which is inconsistent with the action.

"(b) PROCEDURAL REQUIREMENTS.—Before conducting a market test, the Postal Service shall—

"(1) develop a plan for such test which identifies—

"(A) the purposes of the test (and how they comport with the provisions of section 101);

"(B) the duration;

"(C) the anticipated costs for each year;

"(D) the anticipated revenues for each year;

"(E) a specific description of any aspect of the test for which there is a lack of specific authority; and

"(F) a specific citation to any provision of law, rule, or regulation which, if not waived under this section, would prohibit the conducting of the test, or any part of the test as proposed;

"(2) at least 60 days in advance of the date any test proposed under this section is to take effect—

"(A) publish the plan in the Federal Register;

"(B) submit such plan to each House of Congress; and

"(C) provide notification of the proposed test to officers and employees likely to be affected by the test.

"(c) RESTRICTIONS.—No market test under this section may provide for a waiver of—

"(1) any provision of section 410(b)–(d) (or any law applicable to the Postal Service by virtue of any such provision);

"(2) section 412 or any other provision of law (not otherwise covered by paragraph (1)) providing for the nondisclosure of names or addresses or any other information or matter by the Postal Service;

"(3) the limitation on compensation under the last sentence of section 1003(a);

"(4) any provision of chapter 10 (relating to employment within the Postal Service);

"(5) any provision of chapter 12 or of any collective-bargaining agreement under such chapter;

"(6) any provision of section 3623(d) (relating to maintaining one or more classes of mail for the transmission of letters sealed against inspection);

"(7) any provision of law—

"(A) providing for equal employment opportunity through affirmative action; or

"(B) providing any right or remedy available to any officer or employee or applicant for employment in the Postal Service; or

"(8) any rule or regulation prescribed under any provision of law referred to in any of the preceding paragraphs of this subsection.

"(d) LIMITATIONS.—

"(1) DURATION.—Each market test under this section shall terminate not later than 3 years after such project takes effect, except that the project may continue beyond the date on which it would otherwise terminate, if proceedings under subsection (g) are then pending with respect to the product involved.

"(2) DOLLAR LIMITATION.—A market test under this section may not be conducted if the anticipated revenues attributable to such test would, for any calendar year, exceed $100,000,000.

"(e) EMPLOYEES WITHIN BARGAINING UNITS.—Employees within a unit with respect to which a labor organization is accorded exclusive recognition under chapter 12 shall not be included within any market test under this section—

"(1) if the test would violate a collective-bargaining agreement under such chapter between the Postal Service and the labor organization, unless there is another written agreement with respect to the test between the Postal Service and the organization permitting the inclusion; or

"(2) if the test is not covered by such a collective-bargaining agreement, until there has been consultation or negotiation, as appropriate, by the Postal Service with the labor organization.

"(f) OTHER EMPLOYEES.—Employees within any unit with respect to which a labor organization has not been accorded exclusive recognition under chapter 12 shall not be included within any market test under this section unless there has been consultation by the Postal Service regarding the test with the employees in the unit.

"(g) CONVERSION TO PERMANENCE.—A request to make an experimental product (as referred to in subsection (a)) permanent—

"(1) shall be made in accordance with the same requirements as set forth in section 3743(b);

"(2) shall be subject to the same procedures (including review) as set forth in section 3743(c), except as provided in subsection (h); and

"(3) may not be considered unless it is made by the Postal Service.

"(h) TIME LIMITATION ON COMMISSION DELIBERATIONS.—For purposes of applying section 3624 (pursuant to subsection (g)(2)) with respect to a request to make an experimental product permanent—

"(1) section 3624(c) (as deemed to have remained in effect under paragraph (2)) shall be applied with respect to such request in the same manner as would have applied in the case of a request made under section 3622 (as last in effect before being repealed by section 1002); and

"(2) section 3624 (as last in effect before being repealed by section 1002) shall be deemed to have remained in effect, except that subsection (c) of such section (as then in effect) shall be applied by substituting—

"(A) '6 months' for '10 months' in paragraph (1) thereof; and

"(B) '6-month period' for '10-month period' in paragraph (2) thereof.

"SUBCHAPTER V—REPORTING REQUIREMENTS AND RELATED PROVISIONS

"§ 3781. Definition

"For purposes of this subchapter, the term 'product' has the meaning given such term by section 3721(3).

"§ 3782. Reporting requirements

"(a) IN GENERAL.—No later than 3 months after the last day of each fiscal year, the Postal Service shall submit sufficient information to the Postal Rate Commission to demonstrate that the then current rates for products are in compliance with all applicable requirements of this title.

"(b) AUDITS.—

"(1) IN GENERAL.—Before submitting any information under subsection (a), the Postal Service shall have such information audited by an independent professional accounting organization (from outside of government), and such audit shall be submitted along with the information to which it relates.

"(2) ACCESS TO PAPERS AND SUPPORTING MATERIALS.—

"(A) IN GENERAL.—The Commission shall have access to the working papers and supporting materials of an auditor in connection with any audit conducted by such auditor under this subsection.

"(B) CONFIDENTIALITY.—Any information described in paragraph (3) to which the Commission gains access under subparagraph (A) shall be subject to section 3604(g)(2) in the same way as if the Commission had received notification with respect to such information under section 3604(g)(1).

"(3) IDENTIFICATION OF PROTECTED INFORMATION.—

"(A) IN GENERAL.—The Postal Service shall, in accordance with regulations which it shall prescribe, ensure that—

"(i) any protected information shall, before being furnished to an auditor under this section, be appropriately identified (including, to the extent practicable, by being appropriately stamped, labelled, tagged, or otherwise physically marked); and

"(ii) appropriate measures are taken (such as the inclusion of appropriate terms in any contract or other agreement with the auditor) to safeguard the security and confidentiality of protected information.

"(B) PROTECTED INFORMATION DEFINED.—For purposes of this paragraph, the term 'protected information' means any information which, in the judgment of the Postal Service, is information of a type which is described in section 410(c) of this title, or exempt from public disclosure under section 552(b) of title 5.

"(c) ADDITIONAL REQUIREMENTS.—The Postal Service shall submit to the Commission, at the time of making its submissions under subsections (a) and (b)—

"(1) a copy of the then most recent comprehensive statement under section 2401(b);

"(2) a copy of the then most recent performance plan and program performance reports required under sections 2803 and 2804, respectively; and

"(3) for the most recently completed fiscal year, with respect to each product in the competitive category of mail, each product in the noncompetitive category of mail, and each product under subchapter IV—

"(A) market information, including mail volumes;

"(B) postal financial information, including costs to the Postal Service and revenues;

"(C) measures of the speed and reliability of postal service, including—

"(i) the service standard applicable to each product;

"(ii) the actual level of service (described in terms of speed of delivery and reliability) provided; and

"(iii) the degree of customer satisfaction with the service provided; and

"(D) any other information that the Commission and the Postal Service mutually agree upon.

"(d) REGULATIONS.—The Commission shall prescribe regulations specifying the form and detail of the information required under this section, consistent with otherwise applicable provisions of this title. Such regulations shall give due consideration to avoiding unnecessary or unwarranted administrative effort and expense on the part of the Postal Service.

"§ 3783. Use of profits

"(a) DEFINITION OF PROFITS.—For purposes of this section, the term 'profits', with respect to any fiscal year, means the amount by which total income of the Postal Service attributable to such year, exceeds total costs of the Postal Service attributable to such year, as determined by the Directors, in writing, in accordance with generally accepted accounting principles.

"(b) DETERMINATION OF NONCOMPLIANCE.—Not later than 90 days after receiving all the submissions required under section 3782 with respect to a fiscal year, the Postal Rate Commission shall make a written determination as to—

"(1) whether any rates or fees were placed in effect during such fiscal year which were not in compliance with applicable provisions of this title;

"(2) whether any performance goals, established under section 2803 or 2804 for such fiscal year, were not met; and

"(3) whether any service standards for such fiscal year were not met, based on the information under section 3782(c)(3)(C).

"(c) IF NO NONCOMPLIANCE IS FOUND.—If the Commission does not make a timely determination of noncompliance under subsection (b), or if a timely determination is made under subsection (b) to the effect that no instances of noncompliance occurred, up to 100 percent of the profits (if any) from the preceding fiscal year may be used by the Postal Service for the purposes described in subsection (e).

"(d) IF ANY NONCOMPLIANCE IS FOUND.—If the Commission makes a timely determination of noncompliance under subsection (b)—

"(1) the Commission may order, based on the seriousness of the noncompliance, that a specific percentage of the previous fiscal year's profits (if any), not to exceed 50 percent, be set aside for the purposes described in subsection (f); and

"(2) up to 100 percent of the remainder of the previous fiscal year's profits (if any) may be used by the Postal Service for the purposes described in subsection (e).

"(e) BONUSES.—

"(1) IN GENERAL.—The Postal Service shall establish a program under which cash bonuses may be paid to officers and employees of the Postal Service out of any profits which are available for that purpose.

"(2) REQUIREMENTS.—Under the program—

"(A) bonuses may be paid to officers and employees of the Postal Service under criteria which shall be fair and equitable;

"(B) the sole source of funding shall be any profits from any fiscal year, subject to the application of subsection (d)(1) with respect to such fiscal year; and

"(C) subject to subsection (h), bonuses shall not be precluded by the limitation on compensation under the last sentence of section 1003(a).

"(3) DISCRETIONARY NATURE OF PROGRAM.—Nothing in this section shall be considered to create any entitlement to receive bonuses or to require that any

portion of the profits from any fiscal year be used for bonuses in excess of whatever amount the Postal Service considers appropriate (if any).

"(4) CONSIDERATIONS RELATING TO THE PORTION OF PROFITS TO BE AVAILABLE FOR BONUSES.—In any decision relating to what portion of the available profits from any fiscal year shall be available or used for purposes of the payment of bonuses under this subsection, there shall be taken into consideration—

"(A) the duty on the part of the Postal Service to provide efficient and economical postal services in accordance with the requirements of section 101, section 403, and this chapter; and

"(B) what portion of those profits (if any) should be used—

"(i) to retire debts or other obligations of the Postal Service;

"(ii) to limit future increases in postal rates or fees for products in the noncompetitive category of mail; or

"(iii) to carry out any other purpose.

"(f) DEDICATION OF FUNDS TOWARD REDUCING RATES AND FEES.—

"(1) IN GENERAL.—Any amounts ordered to be set aside under subsection (d)(1) may not be used for any purpose other than to defray increases in future rates and fees for products in the noncompetitive category of mail or to reduce the rates and fees already in effect for such products.

"(2) COMPLIANCE.—Whenever an order under subsection (d)(1) is issued, the Postal Service shall include in its next comprehensive statement under section 2401(b) (and each subsequent statement thereunder until the order has been fully complied with)—

"(A) a statement of the measures which have been or will be implemented in order to comply with the order;

"(B) the amount of savings actually passed on to mailers during the reporting period, as compared to the estimated savings for such period; and

"(C) what measures, if any, have been or will be implemented in order to reconcile any difference identified under subparagraph (B).

"(3) NONREDUNDANT INFORMATION.—Nothing in paragraph (2) shall be considered to require that the same information be reported if included in a previous report under this subsection.

"(g) PROCEDURES.—The provisions of sections 556 and 557 of title 5 shall not apply to any review carried out by the Commission under this section.

"(h) REPORTING REQUIREMENT.—Included in its comprehensive statement under section 2401(b) for any period shall be—

"(1) the name of each person receiving a bonus during such period which would not have been allowable but for the provisions of subsection (e)(2)(C);

"(2) the amount of the bonus; and

"(3) the amount by which the limitation referred to in subsection (e)(2)(C) was exceeded.".

(b) REPRESENTATION IN AN ANTITRUST ACTION.—Section 409(d) of title 39, United States Code, is amended by striking "(d) The" and inserting "(d)(1) Except in any instance in which the Postal Service elects to employ attorneys under paragraph (2), the" and by adding at the end the following:

"(2)(A) As used in this paragraph, the term 'antitrust laws' has the meaning given to it by section 3744(b).

"(B) The Postal Service may, in connection with any litigation brought against the Postal Service under any of the antitrust laws, employ attorneys by contract or otherwise to conduct litigation on its behalf without regard to any provision of paragraph (1).".

(c) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Section 410(c)(4) of title 39, United States Code, is amended by inserting "or 37" after "36".

(2) Section 409(a) of title 39, United States Code, is amended by striking "section 3628" and inserting "section 3628 (or any provision of this title incorporating such section by reference) or section 3723(g)".

SEC. 1002. TERMINATION OF RATEMAKING AUTHORITY UNDER CHAPTER 36 AND RELATED MATTERS.

(a) AUTHORITY TO FIX RATES AND CLASSES.—Section 3621 of title 39, United States Code, is amended—

(1) in the first sentence by striking "this chapter" and inserting "this chapter and chapter 37";

(2) by repealing the last 2 sentences.

(b) RATES AND FEES.—

(1) IN GENERAL.—Section 3622 of title 39, United States Code, is repealed.

(2) CLERICAL AMENDMENT.—The item relating to section 3622 in the table of sections at the beginning of chapter 36 of such title 39 is repealed.

(c) RECOMMENDED DECISIONS OF COMMISSION.—Section 3624 of title 39, United States Code, is amended—

(1) in subsection (a) by striking "section 3622 or 3623" and inserting "section 3623";

(2) by repealing subsection (c); and

(3) in subsection (d)—

(A) by striking "rate, fee, or"; and

(B) by striking "section 3622 or 3623, as the case may be." and inserting "section 3623.".

(d) ACTION OF THE GOVERNORS.—Section 3625 of title 39, United States Code, is amended—

(1) in the third sentence of subsection (d)—

(A) by striking "(1)"; and

(B) by striking "chapter, and (2)" and all that follows through the period and inserting "chapter and chapter 37, respectively."; and

(2) by amending subsection (f) to read as follows:

"(f) Except as otherwise provided in this title, the Board shall determine—

"(1) the date on which any changes in the mail classification schedule (whether made under this chapter or chapter 37) shall become effective; and

"(2) the date on which new rates and fees under chapter 37 shall become effective.".

(e) REDUCED-RATE CATEGORIES OF MAIL.—

(1) CONTINUED APPLICABILITY OF RELEVANT PROVISIONS OF CHAPTER 36 FOR THE LIMITED PURPOSE OF COMPUTING ALTERNATIVE RATE LIMITATIONS FOR NON-COMPETITIVE PRODUCTS.—Notwithstanding any other provision of this Act (or any amendment made by this Act), the rate of postage established under subchapter II of chapter 37 of title 39, United States Code, as amended by this Act, for a class of mail or kind of mailer referred to in section 3626(a)(1) of such title may not, at any time, exceed the lesser of—

(A) the maximum rate then otherwise allowable under chapter 37 (determined as if this subsection had not been enacted) for such class of mail or kind of mailer; or

(B) the rate determined under paragraph (2) for such class of mail or kind of mailer.

(2) DETERMINATION OF RATES WHICH WOULD THEN OTHERWISE APPLY UNDER CHAPTER 36.—

(A) IN GENERAL.—For purposes of paragraph (1)(B), the United States Postal Service shall determine, and subsequently revise whenever necessary in order to keep determinations under this paragraph current, the rate of postage which would then otherwise apply with respect to each class of mail or kind of mailer referred to in section 3626(a)(1) of such title 39.

(B) METHODOLOGY.—Subparagraph (A) shall be carried out—

(i) by applying the provisions of paragraphs (2) through (5) of section 3626(a) and of section 3642 of such title 39; and

(ii) by using the then most recent information available to the Postal Service relating to costs attributable and institutional costs (within the meaning of the provisions referred to in clause (i)).

(3) LIMITATION UNDER THIS SUBSECTION TO BE USED INSTEAD OF (AND TO BE TREATED AS) THE LIMITATION UNDER SECTION 3722.—The maximum rate determined for a product under this subsection shall, for all purposes (except paragraph (1)(A)), be used instead of (and shall be treated as) the maximum rate allowable for such product under section 3722 of such title 39.

(4) STATEMENT OF LIMITED PURPOSE.—Section 3626(a) of such title 39 is amended by adding at the end the following:

"(6) Neither this subsection nor section 3642 shall have any force or effect, except for purposes of section 1002(e) of the Postal Reform Act of 1997. Nothing in the preceding sentence shall be considered to affect any baseline rate established pursuant to section 3701.".

(5) REGULATIONS.—The United States Postal Service shall prescribe such regulations as may be necessary to carry out the provisions of sections 3626 (including subsections (b) through (n) thereof) and 3642 of such title 39 (as amended by this Act) in a manner consistent with chapter 37 of such title 39 (as amended by this Act) and with the purposes of this Act.

(f) OTHER TEMPORARY RATES.—

(1) IN GENERAL.—Section 3641 of title 39, United States Code, is amended—

(A) by repealing subsections (a) through (d); and

(B) in subsection (f) by striking "in rates of postage, and fees for postal services, or".

(2) CLERICAL AMENDMENTS.—

(A)(i) The heading for section 3641 of such title 39 is amended to read as follows:

"§ 3641. Temporary changes in classes".

(ii) The item relating to section 3641 in the table of sections at the beginning of chapter 36 of such title 39 is amended to read as follows:

"3641. Temporary changes in classes.".

(B)(i) The heading for subchapter III of chapter 36 of such title 39 is amended to read as follows:

"SUBCHAPTER II—TEMPORARY CLASSES".

(ii) The analysis for chapter 36 of such title 39 is amended by striking the item relating to subchapter II and inserting the following:

"SUBCHAPTER II—TEMPORARY CLASSES".

(g) RATE AND SERVICE COMPLAINTS.—Section 3662 of title 39, United States Code, is amended to read as follows:

"§ 3662. Rate and service complaints

"(a) Interested parties who believe the Postal Service is charging rates which do not conform to the policies set out in this title or who believe that they are not receiving postal service in accordance with the policies of this title may lodge a complaint with the Postal Rate Commission in such form and in such manner as it may prescribe. The Commission may in its discretion hold hearings on such complaint.

"(b)(1) If the Commission, in a classification matter covered by subchapter II, determines the complaint to be justified, it shall, after proceedings in conformity with section 3624, issue a recommended decision which shall be acted upon in accordance with the provisions of section 3625 and subject to review in accordance with the provisions of section 3628.

"(2) If a violation of a limitation under section 3722 or 3724(d) (relating to the maximum rate allowable for products in the noncompetitive category of mail) or section 3742(b) (relating to requirements applicable with respect to rates established for products in the competitive category of mail) is involved, it may issue an appropriate order under section 3783.

"(3) If a matter other than a matter covered by paragraph (1) or (2) is involved, and the Commission after a hearing finds the complaint to be justified, it shall render a public report thereon to the Postal Service which shall take such action as it deems appropriate.".

(h) LIMITATIONS.—Section 3684 of title 39, United States Code, is amended by striking "or 34" and inserting "34, or 37".

(i) MAIL CLASSIFICATION.—Section 3623 of title 39, United States Code, is amended—

(1) by repealing subsection (a);

(2) in subsection (b) by striking "Following the establishment of the mail classification schedule requested under subsection (a) of this section, the" and inserting "The";

(3) in subsection (c) (in the matter before paragraph (1)) by striking "this title" and inserting "this title, subsection (e),"; and

(4) by adding at the end the following:

"(e)(1) Any change under this subchapter in the mail classification system shall be in accordance with the requirements of paragraph (2).

"(2) The requirements of this paragraph are as follows:

"(A) A product may not be reclassified from the competitive to the noncompetitive category of mail.

"(B) The reclassification of a product from one basket to another basket of the noncompetitive category of mail shall not be effective during a ratemaking cycle unless notice of the final decision on the reclassification is given to the Postal Rate Commission before the start of proceedings under section 3723(b) in connection with such cycle.

"(C)(i) A new product may not be made available to the public before it has been placed in—

"(I) either the competitive or the noncompetitive category of mail; and

"(II) if placed in the noncompetitive category of mail, the appropriate basket thereof.

"(ii) Any decision as to whether a new product should be placed in the competitive or the noncompetitive category of mail shall be made in accordance with the requirements set forth in section 3743(b). Such requirements shall be specifically addressed in any statement required under section 3624(d) with respect to such decision.

"(3) For purposes of this subsection—

"(A) the term 'product' has the meaning given such term by section 3721(3);

"(B) the term 'noncompetitive category of mail' refers to the category of mail under subchapter II of chapter 37;

"(C) the term 'competitive category of mail' refers to the category of mail under subchapter III of chapter 37;

"(D) the term 'basket' refers to a basket under paragraph (3), (4), (5), or (6) of section 3723(a);

"(E) the term 'ratemaking cycle' has the meaning given such term by section 3723(a)(1); and

"(F) the term 'new product' means a product which, as of the effective date of this subsection, is not available to the public through the Postal Service.".

(j) EFFECTIVE DATE.—This section and the amendments made by this section shall become effective on the effective date of the baseline rates and fees established pursuant to section 3701 of title 39, United States Code, as amended by section 1001.

Mr. FATTAH. Thank you, Mr. Chairman.

I will ask that my opening statement be entered for the record, and also an opportunity for all subcommittee members to extend and revise their remarks for the record.

There is a lot to get through this morning so I want to be as expeditious as possible, but I do want to welcome the guests, and given the present ratemaking structure involving the Postal Service, I guess there is a question about which basket all of us belong in, because it is a procedure that does cry out for reform.

We talk, we use that term a lot around here, but I think that the chairman is sincere in his efforts to actually have this be a reform that actually improves the provision of universal service and delivery, and it is fair for all involved. Obviously, we need to balance the Postal Service's needs for an expedited process for pricing purposes, but we have to balance that in terms of the public's concern for fairness and accountability, and I look forward to the testimony, and I want to welcome my own constituent from the Wharton School who is here today, and look forward to hearing from all of you and any stock market tips you want to impart.

Thank you very much.

Mr. MCHUGH. I appreciate the gentleman's comments and his interest in expediting the process.

As he noted, both his and all other Members' statements will be entered into the record in their entirety, without objection.

Before we go through the required exercise of swearing in the members of the panel today, let me take a moment to introduce them in the order in which they are printed on this sheet, which has no relation to anything other than that is how they are printed on the sheet.

The first is John Kwoka, who is economics professor at George Washington University; Mr. Kenneth Rose, senior economist at the National Regulatory Research Institute; Joel Popkin, who is president of the Joel Popkin and Co.; Gregory Sidak, who is resident scholar at the American Enterprise Institute for Public Policy Research; Mr. Paul Kleindorfer, who is a professor of economics at the

University of Pennsylvania, as you just heard; and he is joined by Mike Crew, economics professor at Rutgers University.

Before we do the swearing in, I note that the gentleman from New York, Mr. Gilman, has joined us, and I would be happy to yield to him for any comment he would like to make at this time.

Mr. GILMAN. I know that you are anxious to get on with the testimony.

Mr. MCHUGH. Thank you very much. I appreciate the gentleman's understanding.

With that, I would like to ask the panel members to please rise, and I will tell you this is committee practice. It has nothing to do with our doubt of your veracity, but if you will, raise your right hand and repeat after me.

[Witnesses sworn.].

Mr. MCHUGH. Thank you. The record will show that all of the panel members responded to the oath in the affirmative.

With that, let me begin on my right, your left, with John Kwoka. We have all of your testimony in its entirety and made it a part of the record, and that is a very important part of the process. It will be considered in its entirety, I guarantee you, if for no other reason than I don't read something as in-depth as that and then don't use it. It would be helpful.

But we do not have time here today for each of you to present your testimony so we would ask you to limit your remarks to 10 minutes or so, and highlight it as you feel is appropriate. So with that, Mr. John Kwoka, welcome, sir, and our attention is yours.

STATEMENT OF JOHN KWOKA, ECONOMICS PROFESSOR, GEORGE WASHINGTON UNIVERSITY

Mr. KWOKA. Thank you, Mr. Chairman and members of the subcommittee. I appreciate your invitation to appear here today to talk about price caps for the Postal Service. I will try to summarize in just a few minutes the major points of the testimony that, as you said, I have submitted for the record.

A decade ago, price caps seemed like a novel experiment. Some even said it was a radical idea. I remember this well since 10 years ago, exactly at that time, I was on leave from George Washington University working at the Federal Communications Commission on price caps for the telecommunications industry. The price cap plan that I worked on at the time went into effect for AT&T in 1989, and for the major local exchange carriers in 1991.

Since that time, most State public utility commissions have adopted price caps or similar earnings sharing plans for local telephone service. Price caps and other forms of incentive regulation are also now widely used in our electric power industry. On last count, over 40 States have either price caps or other forms of performance-based ratemaking in place for their electric utilities.

In the U.K., British Telecom has been subject to price caps since 1984. So too has been their National Grid Co., the 12 regional electric companies, British Gas, water distribution, water supply companies, and parts of the British Airports Authority.

So price caps, in short, over the past 10 or 15 years, have quite rapidly replaced cost-based ratemaking, rate of return regulation, as the mechanism of choice for overseeing franchise monopolies and

dominant companies generally, and the reasons are well-known to everyone here. Rate of return regulation creates effectively a zero sum gain, where any cost savings achieved by the company are quickly recaptured.

Price caps offers companies a deal. Prices are fixed so that consumers may be made better off than under conventional regulation, but the company gets to keep at least a portion of the further cost savings that it achieves.

The record compiled under price caps, particularly for the companies that I have mentioned, shows that price cap plans can, in fact, work very well. Consider AT&T. At the first review of the price cap performance for AT&T in 1993, the first review 4 years after the inauguration of the plan, the Federal Communications Commission concluded that the added productivity gains that were passed on to consumers in the preceding 4 years totaled $900 million. At the very same time, through that same 4-year period, AT&T's rate of return had risen by a full percentage point, to 13.2 percent, a full percentage point above that last prescribed under rate of return regulation. Taken at face value, this illustrates perfectly the positive sum nature of the gain that price caps create in place of rate of return.

It may in fact be a measure of the success of the AT&T plan that there has never been a second performance review. In fact, beginning in 1991, and concluding last year in 1996, the FCC determined in a series of actions that groups of services previously subject to price caps could be altogether deregulated. Now essentially all of AT&T's prices are set in an unregulated market so that in fact that very important chapter of the history of price caps is now closed.

Most but not all economic studies of the effectiveness of price caps corroborate the favorable assessment of price caps for AT&T. There have been a number of economic studies of which I am aware and which are cited in my written statement. Several of these find that in States with incentive regulation and price caps, telephone service prices are from 4 to 18 percent lower than in States that do not have any incentive regulation in place.

But it's important to point out that at least one study finds some contrary evidence, and all studies find considerable variation in the kind of outcomes that are achieved. The reason is that not all price cap plans work equally well, and in fact some may not work well at all. The reasons are several and are worth enumerating.

Some plans are adopted for companies in particularly difficult business circumstances. Those sorts of contexts are not likely to result in particularly favorable outcomes after an interval of time where the price cap plan is, even after some interval of time that the price cap plan may have been in place not, however, through any fault, necessarily, of the plan itself.

Another difficulty in identifying or being certain of the effects of price cap plans is that many are experimental in nature. This may induce companies to front load benefits in order to ensure continuation of the plan, and not all of the initial benefits may persist in the longer term. Most fundamentally the degree of success of these plans depends on the provisions—the particular provisions—of the plans themselves.

Let me offer some observations about the aspects of the plans that I think are most decisive in influencing their prospects for success, with some reference to their applicability to the Postal Service.

First and foremost, a good price cap plan must work to the advantage of both consumers and the companies. If it does not, it will be seen as serving one party's interests and it will soon be discredited. For a price cap plan to have consumer benefit, price must, on average, be lower than under alternative regulation. This requires a pricing formula that demonstrably brings price down, at least for critical consumer services. That requires in turn a choice of a price index and productivity offset, as I discuss in my written testimony, together perhaps with baskets and pricing bands, that reflect important policy interests.

Plans with poorly chosen price formulas, and there have been some in this country and elsewhere, have not succeeded. For a price cap plan to benefit the company, there must be strong incentives for true cost savings. This requires a commitment on the part of those who initiate regulation to allow the enterprise, in fact, to retain the added earnings from truly superior efficiencies that may be achieved. In the case of the Postal Service, this task is made more difficult, as we recognize, by the fact that there are no private shareholders to insist that the enterprise minimize cost or maximize profit.

The alternative would appear to be an incentive structure to motivate and reward officers and employees in a fashion that adequately compensates for the added productivity gains that are being sought. Plans where efficiency benefits are not clear, not adequately rewarded, or subject to manipulation have not succeeded, and there have been examples of that both here and abroad.

In addition, there may be legitimate concerns about service quality since quality erosion lowers cost, and for that reason may produce earnings to the company. There's no systematic evidence of which I am aware that price cap plans suffer from this problem as a general rule, but there are any number of anecdotal experiences that underscore the fact that service quality requires continued vigilance.

Finally, nothing helps a successful adoption and launch of a price cap plan quite so much as keeping the task simple. To the extent that additional issues can be postponed and added complexity avoided, to the extent that other objectives need not be considered at the same time, then the cut-over to rate of return or cost-based regulation will be facilitated.

So issues such as entry into new markets, universal service, and rate initialization may all deserve consideration. Indeed they do, but since none is distinctive to price caps, it may be advisable to separate those issues from the simple choice between a superior versus are inferior mechanism of regulation and allow those other issues to be revisited separately at an appropriate time.

Thank you very much, Mr. Chairman, and members of the committee. I will be happy to answer questions at any time.

Mr. MCHUGH. Thank you, Mr. Kwoka.

[The prepared statement of Mr. Kwoka follows:]

Mr. Chairman and Members of the Subcommittee:

Ten years ago the telecommunications and electric power industries in this country, like the postal service now, were largely subject to traditional cost-based regulation. Under such regulation, the prices charged by AT&T, the Bell Operating Companies, and myriad electric power companies was set in seemingly the most obvious manner. The costs that these companies incurred were recovered by pricing the service, on average, at the level of incurred costs per unit of service.

Cost-based regulation, however, was and is subject to serious and well-known limitations. Although the process is subject to oversight, prudence review, and possible cost disallowance, the company has no real incentive to conserve on costs. To the contrary, the incentives it faces encourage excess costs which can simply be passed on in the form of higher price. The regulator--whether the Federal Communications Commission, the Federal Energy Regulatory Commission, state public utility commissions, and, yes, the Postal Rate Commission--operates under the inherent disadvantage of less and less reliable information than the regulated company. The inevitable consequences are excess costs, distorted prices, and consumer harm.

By 1987 the FCC became convinced that cost-based regulation of the telecommunications industry was performing ever more poorly. These general problems of cost incentives were exacerbated in a telecommunications market increasingly characterized by new services, some of which were subject to

competition, and a dominant company (AT&T) operating in both traditionally regulated and newly competitive markets. Cost-based regulation by even the most vigilant regulator was simply not capable of dealing with such novel, complex, and fast-changing issues. The time had come to examine alternatives.

Encouraged by economic analysis and some international experience, the FCC proposed to adopt a price cap plan to replace rate of return regulation for AT&T. Over the next year and a half while on leave from George Washington University, I had the opportunity to work at the FCC with major responsibility for devising that price cap plan. In 1989 our goal was achieved with the implementation of the plan for AT&T.

In 1991 an analogous plan began operation for the access services provided by the Bell Operating Companies and other major local exchange carriers. During that time and subsequently most states have modified their regulation of the intrastate businesses of these companies. At present sixteen states have adopted price caps and another seventeen have earnings-sharing mechanisms or other alternatives to rate of return regulation. Much of the $100 billion telecom industry, in short, is or has been operating under price cap regulation.

Similar forces have been at work in the $200 billion electric utility industry. Even in the mid-1980s a number of states had begun experimenting with various types of incentive regulation for purposes of cost efficiency, energy conservation, or both. Some twenty states had such plans in 1986. This list

has grown to the point where at least 41 states now utilize either true price cap plans or some other mechanism of "performance-based ratemaking."

Other countries' experience with price caps is at least as extensive. Even prior to our AT&T plan, the British had adopted price caps for its dominant telecommunications carrier, British Telecom. Subsequently in the UK, price cap plans have been instituted for the National Grid and the Regional Electric Companies (transmission and local distribution, respectively) that resulted from fragmentation and privatization of the electric power sector. Price cap plans have accompanied similar transformations of the UK gas and water utilities. British Gas was privatized and subject to price cap regulation for most customers in 1986, as were the ten regional water supply companies in 1989. Even certain services provided by British Airports Authority for southeast UK airports are price-capped. In addition, numerous other countries have adopted price caps for their major utility and infrastructure industries.

Against this backdrop this Subcommittee's consideration of H.R. 22 represents an historic opportunity to extend the application of price caps to postal services. What I would like to address in the remainder of my statement is the principals of price caps, experience with them in telecommunications, and their applicability to postal services.

As I noted, cost-based regulation insures a company against losses--even if the losses result from unnecessary costs--by

automatically adjusting price in lockstep with reported costs. Price caps, by contrast, decouples price from cost and in so doing confronts the company with the consequences of its cost reduction efforts and actual experience. If costs are above some norm, the company will suffer losses, but if it achieves unusually low costs, the resulting profits are its to keep: A billion dollars saved is a billion dollars earned.

Although the incentive effects are clear, questions remain: What is the norm at which price should be set? How should price change over time? How should each individual price be set? What happens if unacceptable profits or losses nonetheless occur? The answers to these questions define each particular price cap plan, and they also determine its prospects for success in achieving its objectives. Let me outline the nature of each of these issues and the approach that should be taken:

First, how should price be initially set? In principle, they should equal the level of "good-practice" costs. This results in breakeven operation by the company, with neither profit windfalls nor shortfalls. But determining good-practice costs is not necessarily straightforward, since if it were, price would probably already be at that level. As a consequence, most price cap plans, including those for AT&T and the LECs, have adopted existing rates as the point of departure.

The rationale for initializing rates at existing levels is threefold: Such rates presumably represent the best current estimate of appropriate rates. In addition, since they represent

the rates that would exist under continued cost-based regulation, any alternative that lowers prices relative to that benchmark constitutes an improvement. Initializing rates at existing levels has the further practical advantage of avoiding taking on rate review simultaneously with price reform. A simultaneous rate review would give the company one additional opportunity to seek advantageous rates, and might even jeopardize reform itself.

Second, even if prices are initialized at acceptable levels, how can appropriate prices be maintained in the face of inevitable changes in underlying costs? Apart from some very short-run plans that simply freeze rates temporarily, price cap plans address this by indexing rates in accordance with those factors that alter costs. As a general economic proposition, service costs vary with changes in the prices of inputs used in producing the service, net of productivity gains. An accurate pricing formula should track future costs well, set price at an appropriate level, and provide a continuously updated efficiency target for the company.

From this stems the well-known formula for price caps: GDPPI - X. The Gross Domestic Product Price Index (GDDPI) is chosen because, among major price indexes, it best captures the production cost experience of companies at large. The X factor is the annual rate of change in a company's productivity relative to economy-wide productivity. For AT&T X was set at 3.0 percent, based on an examination of the economic literature, a study of its past price experience, and additional recent evidence

introduced into the record. For the LECs, it was initially set at 3.3 percent (which many correctly believed understated their productivity).

Third, even the best-designed formula will inevitably diverge from underlying costs over time, raising the question of whether, and how, the regulator should intervene. Failure to intervene may result in persistent, substantial profit windfalls or shortfalls that are unacceptable on both economic and political grounds. But frequent intervention that, for example, resets parameters based on recent profit performance defeats the plan itself, as the company recognizes that it does not really face the full consequences of its cost initiatives or lack thereof.

Thus, only when it is clear that the plan parameters have produced a cap that diverges significantly from underlying conditions should there be administrative intervention. And even then, caution must be exercised since intervention closely based on past performance will undermine the plan's incentives. In an effort to avoid this pitfall, the price cap plan for AT&T provided for a four-year "performance review" based on numerous factors, including "actual prices, achieved rate of return, quality of service, and technological progressiveness." The performance review for British Telecom focused closely on its increased earnings during the preceding five years and prompted the regulator to increase the X factor from 3.0% to 4.5% (and then to 6.25% and 7.5%) on grounds that struck many as closely

analogous to rate of return principles.

The price cap formula and adjustment process for the LECs were structured differently. Since less was reliably known about their productivity, a best-guess X factor was employed but not expected to track cost changes nearly so well as that for AT&T. Consequently, a "sliding scale" was incorporated which automatically adjusts the plan parameters whenever profit deviations grow large. Specifically, beyond some zone around a rate-of-return norm, yearly over- or under-earnings were to be shared between the company and consumers. This mechanism essentially "recenters" the formula on a more frequent basis, but it does not do so through ad hoc intervention and, moreover, it assures substantial earnings retention to the LECs.

Fourth, there remains the question of individual service prices under caps. Between the extremes of a separate cap for each price and a single weighted-average cap lies the usually appropriate choice--a limited number of service baskets, with secondary pricing bands within each. A broad cap gives pricing discretion to the company and simplifies plan administration. But it also allows rapid price changes, substantial revenue shifts among customer categories, extraction of excess profit on inelastically demanded services, and price reductions strategically designed to impede competition on others.

For these reasons, the price cap plan for British Telecom has two baskets, that for AT&T three, and those for the LECs have four. Services are grouped according to their cross-elasticity--

that is, the ease with which consumers might switch among them--and the degree of competition that the services faced. These criteria minimize adverse effects on any single customer category and limit the opportunity for strategic pricing where competition threatens. Each basket is subject to its own price cap, although in the absence of any basis for a different price index or productivity factor among the baskets, all are identical.

Pricing bands are annual limits on individual price movements around the overall cap for a particular basket. These are intended to moderate the pace of price changes in order to allow consumers adequate opportunity to adapt to restructured prices, and to prevent the swift price changes characteristic of strategic and predatory pricing against competitors. Bands have often been set at a five-to-ten percentage point change relative to the cap. Since the limits are annual and cumulate, they do not ultimately preclude price changes of a more substantial nature.

In addition to these issues, most price cap plans in some fashion address other matters of a technical, incentive, and policy nature. Let me simply list these:

· There needs to be some provision for incorporating new services and restructured services into the cap, and for removing abandoned services from it. Given the weighted average nature of the cap, this requires some care in formulation.

· Attention must be paid to the circumstance where some services are subject to varying degrees of competition and may be

held outside the cap. The price at which such services can be offered, the treatment of common costs, and other matters will greatly affect the prices of both the regulated and now-unregulated services.

• Guidelines must exist for allowing the company to offer customer-specific, bundled services. These may represent good business practices in an increasingly competitive market, but also may serve to target and preserve the very customers (and only those customers) for which rivals can compete.

• Certain wholly exogenous costs should be treated separately from the basic formula and passed through directly to final price. The rationale for such exclusions is that the company cannot achieve cost efficiencies on such things as mandated accounting changes, tax law changes, and (in the case of AT&T) access charges, and hence they should not be indexed.

• There must be some mechanism for overseeing and insuring service quality. Relative to cost-based regulation, price caps may enhance the risk of quality erosion as the company seeks to reduce costs.

• Most price cap plans contemplate the deregulation of some services, perhaps even full deregulation of the company. Prospective deregulation relieves some of the burden of trying to fine-tune the plan for the long term, and it is facilitated by defining service baskets according to the level of competition.

While all of these issues require attention, it should not be concluded that developing viable and effective price caps

represents an insurmountable task. To the contrary, as I noted, numerous plans have been developed over the past ten to fifteen years in telecommunications and other industries. Moreover, experience under these plans has been quite favorable. Let me offer a summary of experience with plans in telecommunications and electricity, with which I am most familiar.

The price cap plan for AT&T began in 1989 and was reviewed by the FCC in 1993. Most observers felt that the plan had worked quite well to that point. For its part, the FCC contended that the productivity offset in the plan had resulted in consumer gains totalling almost $900 million, with another $900 million due to below-cap pricing. Simultaneously, AT&T's earned rate of return rose to 13.2 percent, more than a percentage point above its last prescribed rate under regulation. Some questions were raised about deterioriation in certain service quality measures, although no clear connection to price caps was made. Pricing flexibility had served the purpose of allowing significant changes in relative prices without the need for close regulatory review. Many specific AT&T services were priced below their maximum levels, the result of both competition and the averaging requirement of caps.

In 1991 the FCC came to the determination that AT&T's business services (Basket 3) were subject to substantial competition and effectively deregulated most of them. Basket 2 services were deregulated with the advent of 800 number portability in 1993. The following year, the Commission came to

a similar conclusion regarding AT&T's commercial services within Basket 1. In 1996 residential services and international services were also deregulated, effectively ending the era of price caps for AT&T.

The price cap plan for the local exchange carriers went into effect in 1991 and was subject to FCC review four years later. Due to continuing changes in the legislative and regulatory provisions governing LEC operation, substantial aspects of that review are still in process. In its Notice of the 1995 review, the FCC declared that LEC interstate access rates had declined by $1.5 billion, of which nearly $400 million was due to below-cap rates. It also observed that profits of all the of capped LECs had risen, on average by a full percentage point, with some substantially more. Service quality was said to be holding fairly steady, although as with AT&T, some areas of concern were noted.

Several aspects of the LEC price cap plans, most especially the productivity offset, were controversial. Indeed, in this review the FCC acknowledged an error in the original calculation of productivity and raised the new X factor to a minimum of 4.0 percent. A high-productivity option--5.3 percent offset--with no sharing was also offered, and ultimately chosen by all the companies. Other revisions to the plan involved restructuring the baskets, virtually eliminating lower bounds on price changes, and similarly deregulatory changes.

Apart from details of these specific experiences, several

economic studies have examined the impact of price cap plans more generally. Four studies have examined the relationship between incentive regulation at the state level and the price of intrastate services. Three of them--by Mathios and Rogers, by Kaestner and Kahn, and by Tardiff and Taylor--find prices in states with incentive regulation to be lower by anywhere from 4 to 18 percent. There is, however, considerable variation and a number of anomolies in these findings. A later study by Blank, Kaserman, and Mayo even suggests the possibility that prices may be higher with the flexibility afforded by incentive regulation.

Three studies have examined the productivity consequences of price caps. Schmalensee and Rohlfs conclude that AT&T's increased productivity in the three years following price caps resulted in an added $1.8 billion in cost savings. My own study of British Telecom found that its productivity rose by 22% during the initial four years of price caps relative to its previous experience. Tardiff and Taylor report that incentive regulation results in an incremental 2.8% annual gain in local telephone company productivity.

Tardiff and Taylor's study is noteworthy in one further respect: It conducts perhaps the the sole systematic study of the quality consequences of price caps, finding no significant difference in a summary index of quality change for local telecommunications companies in states with and without incentive regulation. Interestingly, though, states where quality was an explicit regulatory factor influencing allowed earnings did

achieve greater quality gains.

Thus, the evidence to date regarding price caps and related forms of incentive regulation is largely favorable, though not without exception. In their recent review, Kridel, Sappington, and Weisman note several reasons for ambiguity. These include the wide variety of plans, each with its own degree of incentives and other distinctive properties; the recent and sometimes experimental nature of the programs; and the confounding influence of other major changes at work in telecommunications.

These limitations also emerge in studies of the effects of incentive regulation in electric power. Berg and Jeong, for example, fail to find any significant operating improvements in the case of electric utilities subject to state incentive programs. My own recent study even finds costs to be higher in those states. In both cases, however, it is quite possible that incentive programs are simply put into place where cost inefficiencies are greater, creating difficulties in isolating the causal effect of the programs themselves.

To repeat, the balance of evidence still favors the application of price cap plans, though some caution in expectations seems advisable. Programs instituted in unfavorable settings, programs with weaker incentives, programs with features more easily manipulated by the company will predictably have lesser effects. For that reason careful attention to the design and implementation of price cap plans is crucial to their prospects for success.

In this spirit, let me offer some observations prompted by my reading of H.R. 22 together with conversations with your staff, which has done such an able job of outlining a price cap plan for the Postal Service. I must emphasize that these comments represent my preliminary effort to apply lessons from other price cap plans to a context about which I know considerably less.

First, application of price caps to the Postal Service would represent an unusual circumstance in that the company is obviously not a private profit-making enterprise. That fact raises an important question of who is (in economic terms) the "residual claimant," the person or persons who has the ultimate financial interest in maximizing profits. Shareholders perform this function for publicly held corporations such as AT&T, other telecommuncations carriers, electric utilities, and so forth. The costs and benefits from price caps fall on them, and they work to ensure that their agents--company managers--pursue their objectives.

But who is the residual claimant for the Postal Service? To whom do excess profits or losses accrue? The answer would appear to be the U.S. Treasury and ultimately the taxpayers of this country. But the Treasury Department cannot buy or sell its "ownership" in the Postal Service, nor can it make its management pursue maximum profit. So, unless ownership of the Postal Service changes, the fundamental question remains: Who is it that can be confronted with monetary incentives to improve the

efficiency of the Postal Service?

The answer would seem necessarily to be the management and employees of the Postal Service. Indeed, as H.R. 22 provides, the Postal Service can distribute its profits in the form of bonuses to its officers and employees. But the potentially important differences with private enterprise do not end there. If incentives are the issue, precisely who should get bonuses? If it is the case that employees are presently paid in excess of their market wage, should they get additional bonuses? If profits are exceedingly large, would one still distribute potentially enormous sums in the form of bonuses? If not, should the Treasury share in the excess? And what if losses accrue? Who, if anyone, should bear the adverse financial consequences?

Second, the co-existence of competitive and noncompetitive services offered by the Postal Service raises significant issues. Under cost-based regulation, an enterprise selling both has every incentive to misallocate costs to ("cross-subsidize") its regulated businesses. Under price caps, the direct monetary incentive to cross-subsidize is blunted in direct proportion to the "toughness" of the cap, that is, the degree to which the price cap parameters will not be changed despite any losses incurred by the enterprise. Even in the case of telecommunications, many doubted that price caps succeeded in truly preventing such actions, since those plans (like all) consider profits in the review.

In the case of the Postal Service, this concern would seem

at least as substantial. Its competitors already object to some of its pricing as divorced from underlying costs. There does not seem to be the same long tradition of regulatory accounting that at least partially contrained AT&T and made its pricing predictable, if not always efficient. And the provisions of H.R. 22 regarding market tests of experimental services may exacerbate this problem since it would allow the Postal Service more readily to enter additional markets, including some where the economic rationale is not clear. The regulatory task and the plight of competitors are both exacerbated by a permissive stance towards entry into additional markets.

Third, for the price cap formula to track future unit costs, it requires a price index that correctly captures Postal Service costs and an X factor that represents "good practice." The GDPPI is a good default index, but I would keep an open mind as to alternatives that may do a better job. It is imperative in any case that the chosen index lie outside the enterprise's influence.

With respect to the offsetting X factor, I would strongly urge that it be one thing only: a target for Postal Service productivity. That is, after all, what the X factor is intended to measure in the economic formula. I would also strongly urge that it be truly fixed for some reasonable interval such as the five year cycle in H.R. 22. Only if the target is known to be truly fixed, rather than being subject to more frequent reconsideration, will the enterprise face real incentives for

cost efficiencies. I would also urge that the same formula--specifically, the same value of the X factor--be employed for each basket of services, unless there is very compelling evidence of different cost or productivity forces at work in each.

Fourth, H.R. 22 proposes relatively limited discretion for individual rates within each cap. For the first basket, each individual service price is capped, effectively implying multiple individual caps. In fact, such a formulation is often termed "indexed rates," rather than price caps. For the other baskets, too, subclass rates are capped without the ability to average price increases against decreases among them. I would urge consideration of added flexibility within each basket, with bands (floors and ceilings) to inhibit whatever price changes are deemed undesirable.

Fifth, while I generally disfavor re-initialization of rates, I acknowledge that there may be exceptional circumstances. If rates diverge demonstrably and unusually from costs, the company, its consumers, or its competitors may be affected in unwanted and persistent ways if no changes are made at the outset. I would simply note that, given the importance of the rates that emerge from "one last rate review," enormous pressures are likely to be placed upon the process.

Finally, I would recommend adoption of an Actual Price Index, different from the Price Cap Index that sets the maximum weighted average price. An API allows for the possibility that the Postal Service would not necessarily utilize all the upward

pricing discretion it is allowed in any year. While the PCI would continue to track its allowed price from year to year, the API would ensure that the Postal Service could carry over any unused pricing discretion to future years.

In summary, I would commend this Committee for its interest in applying price caps to the Postal Service. I know from first hand experience the challenge that such an undertaking poses. I worked with several other individuals at the FCC for more than a year and a half to develop the plan for AT&T, aided (at least sometimes) by notices of proposed rule-making, expert submissions, and the opportunity to get questions answered.

Devising a price cap plan for the Postal Service is, of course, facilitated by the range of past experience on which to draw. But price caps in the present context raise some unique and complex issues, and each plan is inevitably different in important ways. I have tried to highlight those issues that, based on my experience and understanding, will most critically affect the prospects of success of the plan for the Postal Service. I hope these comments may be of some use to you in ensuring that success.

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Mr. MCHUGH. I think in order to keep some continuity here, we should hear from all the panelists and engage in whatever followup discussion is appropriate. So Dr. Rose, if you would please give us your presentation now, and we appreciate you being here.

STATEMENT OF KENNETH ROSE, SENIOR ECONOMIST, THE NATIONAL REGULATORY RESEARCH INSTITUTE

Mr. ROSE. Thank you, Mr. Chairman, and thank you to the other members of the subcommittee and staff.

What I primarily do is work with utility regulation, and actually primarily electric regulation, so looking at price caps being applied to something that I haven't previously done any work in before was quite interesting, and I enjoyed the opportunity to do that and I thank you for asking me to participate in this.

I am going to try to bottom line it as best I can for how I think price caps would work for Postal Service regulation. I will first paint a little picture of the issue that's probably not much different than what Professor Kwoka outlined.

There's a survey in my written testimony that outlines some of the details of the specifics of the plans that the States are doing, and I won't go into detail, but just say right now in telecommunications at the State level, price caps is really the norm now, it's not really the exception anymore. It's not—could hardly be called an alternative form of regulation, although it is more rare for gas and electric utilities. In fact, it was just starting to get off the ground a little bit for electric when the restructuring of the industry hit, it seems to have stalled in that industry at the moment.

In general, I would say that price caps have obtained the initial objective of holding down costs and prices and increase productivity. While there is some contradiction in the literature on that, it seems to be pointing in that direction.

There does appear to be a problem with quality of service, and as Professor Kwoka pointed out, the academic literature and some of the studies are contradictory on that, but the States, if you talk to people in several States that have actually implemented price caps, they are quite convinced that there is a problem with service quality degradation. They have instituted plans to make sure that that doesn't get to an alarming level. In the survey, as I mentioned, we found that there were 16 States that have a quality of service mandate of some kind and I think it's safe to say that the number appears to be rising over time.

One fortunate thing about quality of service, though, is that it can be mitigated; this isn't an insurmountable problem. It's something that has to be looked at, and I would recommend some kind of provision be put into the law.

My reading of H.R. 22 has quality of service provisions in two different places, one for the establishment of the initial rate, it appears to be mentioned also when determining the adjustment factor, quality of service is also mentioned again, which seems to give the PRC some latitude in adjusting the prices of the Postal Service to account for any decrease in the quality of service. However, it wasn't clear to me if the PRC would be able to impose some kind of financial penalty after the initial rate has been set and in between the adjustments being made. States have done it in several

ways to implement these penalties. One way is to add something to the productivity factor, they decrease the amount of the potential increase, or increase the amount of the decrease, depending on the relative size of the price index and the productivity index.

I think what it comes down to is if a regulator is thinking about whether to have cost of service regulation or price cap regulation, one way of looking at it is to ask which is easier to monitor. Is it easier to monitor the cost, which is very costly, of course, we have learned from the utility experience, prudence reviews, very intensive rate cases that last a long time, sometimes up to 2 years or more and often are litigated past that, or is it easier to monitor quality of service? I would argue it's easier to monitor quality of service, and my read on Postal Service regulation is I think it's true there as well.

My largest concern that I have, though, in applying price caps at the Postal Service was one significant difference, I think there is between with the Postal Service with utilities. This is primarily what it is that motivates them. Price caps are really effective, I think it was just obvious, because it picks up on the drive for profits as really the motivating factor, or to avoid the imposition of some kind of penalty. And while the Postal Service I understand is financially independent and is regulated by the PRC, and in that sense it's very similar to a utility, in many other ways it's very different. I think that's one striking difference.

In the case of a price caps, the harder a firm works, the more potential the firm can gain. There are some limits in H.R. 22 that seem to diminish perhaps any kind of an incentive proposal, although there were bonus provisions in there. Perhaps to get around this limitation, one way would be to enhance or strengthen the bonus provisions that are already in H.R. 22 or allow the PRC to decide how to do that.

I think it comes down to a matter of what's the objective. If the objective is to make Postal Service regulation easier, then the price caps may be a viable alternative because it will probably be easier to monitor things like quality than things like cost. If the objective is to really lower cost and get the prices down and increase productivity of the Postal Service, then I am somewhat in doubt whether or not you will get that response from the Postal Service, given the kind of incentive structure that they have and the possibility of a dampening effect because they don't have a profit motive.

Let me summarize by saying that price caps have been successful in lowering prices and increasing productivity. There's little doubt in my mind that it has reached that objective. Quality of service may be a problem, and at the very least it ought to be monitored. The evidence that we have, even though it may be anecdotal, suggests to me it's not something that should be overlooked.

There is an opportunity I think to use price caps here for the Postal Service, but with the caveat that perhaps some kind of strengthening of incentives or penalties that might be imposed for any possible future decrease in quality of service, those provisions may be strengthened to get the desired effect your subcommittee

is after.

Thank you very much, Mr. Chairman.

Mr. McHUGH. Thank you, Dr. Rose, for your comments and your prepared testimony.

[The prepared statement of Mr. Rose follows:]

Thank you for this opportunity to speak to the Subcommittee on the Postal Service today on the subject of price caps. The subject of price cap regulation has been of considerable interest to state utility regulators for some time. The Subcommittee can take advantage of the experiences gained from implementation of price cap programs by the states and federal regulators in the U.S. and in other countries.

Briefly stated, for the Subcommittee's information, The National Regulatory Research Institute (NRRI) is the official research arm of the National Association of Regulatory Utility Commissioners, an association of federal and state utility, transportation, and other industry regulatory agencies, including the Postal Rate Commission. NRRI conducts research primarily on electric, natural gas, telecommunications, and water regulatory issues. We are affiliated with and located at The Ohio State University in Columbus, Ohio. The majority of our funding comes from the state public utility commissions with occasional funding from federal agencies and departments.

My testimony is divided into three parts, the first section provides a basic description of price caps, why it is seen as a superior way to regulate than traditional cost of service, and what and how states are using price caps today. The next section discusses some of the more important implementation issues that states have dealt with over time through their experiences with price cap programs. The final section discusses the application of price caps to the Postal Service as proposed by the Postal Reform Act of 1997 (H.R. 22). Because of my specialization in utility regulation and who our main clientele is, the perspective is primarily from the experiences and practices in the utility field with price caps at the state level.

BASIC DESCRIPTION OF PRICE CAPS

Price cap regulation belongs to a family of noncost-based rate regulation that has been dubbed "performance-based regulation" or PBR. Other forms of PBRs include targeted incentives and yardstick regulation. Price cap regulation is seen as an alternative to the more traditional and longstanding form of regulation, cost of service or rate-base/rate-of-return regulation. The main feature of PBRs is that the regulated firm's performance is compared to

and rewarded or penalized based either on its performance relative to others in the same industry or on an administratively determined benchmark. This is in contrast to traditional cost of service regulation where the firm's costs are primarily examined in the context of that firm only.

In the last decade, a general consensus has developed in the regulatory community that cost of service regulation has serious drawbacks. These limitation are now well known and documented; in general, these include:

- the regulated firm may overinvest in capital, including both rate base inflating as well as more subtle preference for capital over other inputs;

- there are inadequate incentive to minimize production costs in the long-run;

- market risks (associated with changing market conditions) may be shifted to ratepayers and little reward is given to the regulated firm for good decisions;

- there are inadequate incentives to respond to changes in consumer preferences and adopt new and innovative technologies;

- the regulated firm may try to shift costs from unregulated to regulated activities and shift profits from the regulated activities to the unregulated (or, cross-subsidize); and

- cost of service has high administrative cost for the regulated firm, regulators, and interveners from extensive hearings, appeals, prudence reviews or oversight of the firm's operations.

To counter these limitations, regulators over the years have used audits, used and useful tests, prudence reviews, detailed rate cases, and other means. Of course, this means that the administrative cost of this type of regulation increased even more. In contrast, price caps are believed to offer the following benefits:

- they create better incentives for cost reduction and control;

- they have been used in some industries for years, so implementation issue are becoming better known and anticipated;

- they are relatively simple to administer compared with cost-based regulation;

- they allow more price flexibility for the firm to arrange individual contract terms with customers;

- they can protect customers with few or no practical alternatives; and
- they can be used as a transition tool to a competitive market.

The reason that price cap regulation improves the incentive to control costs is that it severs the link between the rate the firm can charge and its costs. Under cost of service regulation, because of limited resources, even a vigilant regulators cannot police every option a firm has and every decision the firm makes. As a result, most justifiable costs are passed along to ratepayers and the incentives for cost control are weak. In addition, the firm is limited in what return it can earn irrespective of how good or bad it performs. Price cap regulation shifts the emphases from monitoring the firm's costs to prices and replaces the oversight of costs that the regulator would do with an incentive that is similar to what a competitive firm would face. The firm can only charge up to the cap, that acts like a market price and, if the firm can reduce its costs, it can retain either a portion of or all of the resulting profit. As will be discussed below, however, if the firm remains essentially a monopolist or operates with limited competition, there may be other unintended consequences of price cap regulation.

The basic price cap formula provides the percentage annual change in the price for a group or class of customers based on a price and a productivity index. The formula may also have an adjustment factor for idiosyncratic or company specific costs or benefits. The formula can be written as:

$$\Delta P_{it} = (\Delta PI_{(t-1)} - X_{(t-1)}) \pm Z_{(t-1)}$$

where

ΔP_{it} = percentage change in the price of electricity for customer class i for period t,

$\Delta PI_{(t-1)}$ = percentage change in the price index for latest reporting period,

$X_{(t-1)}$ = productivity offset calculated from latest reporting period data, and

$Z_{(t-1)}$ = adjustment factor for company specific costs from latest period.

STATE IMPLEMENTATION OF PRICE CAPS: SOME IMPLEMENTATION ISSUES

Table 1 summarized some of the main features of price cap programs used by states for their local telecommunication companies. Currently, thirty-eight states have some type of price cap or rate freeze program. Of these programs, twenty-nine are actual indexed price caps, five are rate freezes, and four are non-indexed price caps.[1] The attached survey is a more detailed state-by-state summary of state plans.

Table 1. Summary of state telecommunication price cap regulation in the United States, as of April 7, 1997.

States with some type of price cap plans	38
States with indexed price caps	29
States with rate freeze	5
States with non-indexed caps	4
States using GDP-PI/GNP-PI as inflation index	26
States using CPI as inflation index	4
Price cap plans with revenue/profit sharing	4
Price cap plans with penalty for quality of service degradation	16
Price cap plans with freeze on basic rates	33
Price cap plans with required infrastructure investment	18

Sources: State Telephone Regulation Report, March 20, 1997, pp.1-9, Vol. 15, No.6 and April 3, 1997, pp.1-8, Vol. 15, No. 7 and conversations with selected commission staff, April 1-4, 1997.

Determining the price and productivity indices

The productivity offset is intended as an overall measure of net productivity change in the industry relative to the overall economy. The bracketed terms ($\Delta PI_{(t-1)} - X_{(t-1)}$) together are intended to estimate the industry's increase in costs during the period. Alternatively, a regulator could use an index of the industry's costs in place of these terms. However, such measures are usually not available; therefore, most price cap programs use a broad economy-wide measure of price change with a productivity offset. The logic behind this method is that since a price index

[1] A price cap allows the firm the flexibility to charge below the cap, while a price freeze fixes the price at a set level.

is used rather than a cost index, an offset is required to estimate net cost increase (net of any productivity change). For the price index, twenty-three states use the Gross Domestic Product Implicit Price Deflator (GDP-PI), three states use the Gross National Product Implicit Price Deflator (GNP-PI), and four states use the Consumer Price Index (CPI).

In practice, regulators have not used the productivity offset in a precise and exact way, but rather as an adjustment factor. For example, a regulator may decide that prices under a price-cap mechanism should be less than they would have been if the firm were still cost-based regulated. In this case, the regulator would raise the productivity offset by an amount sufficient to meet the goal. This sets a more stringent target, whereby the firm must increase its efforts to reduce costs. The Federal Communications Commission added a "consumer dividend" of 0.5 percent to the productivity offset of 2.5 percent in a price cap plan for AT&T's interexchange activities. This was intended to guarantee that customers would share the performance improvement expected to result from the incentive plan.

A concern that some have is that when the terms $(\Delta PI_{(t-1)} - X_{(t-1)})$ ceases to be an attempt to estimate the firm's cost increase, it instead becomes more a means to control earnings. This, of course, was the primary intent of cost of service regulation. The question then is, do we have defacto rate-of-return regulation with the same limitations noted above? In other words, have we simply replaced the issue of allowed rate-of-return with a confrontation over the productivity factor and what expenses should be allowed with the size of the consumer dividend? If this is in fact what is happening, then clearly we are likely to be no better off than with cost of service regulation. The regulator needs to find a balance between sufficient incentive to influence the "correct" behavior where the firm believes that its gains will not be taken away by having the productivity factor raised versus a productivity factor that is too low and too easy to beat. The evidence suggests, so far, that rates have in fact decreased and productivity has increased under price cap plans, suggesting that state regulators have struck a good balance overall.

Profit sharing

Some price cap programs contain a separate equation that allows a firm to retain all of the profit (or incur all the loss) up to some predetermined rate of return on equity, sometimes called a

"dead-band region." Alternatively, there may be no dead-band region and customers share some portion of the profit or loss. Currently, four states have plans with revenue or profit sharing arrangements. However, profit sharing provisions were more common when price cap plans were first being instituted. This may have been more an indication of the uncertainty as to what would happen under the price cap plan and how profitable it would be for the firms than a policy of allowing customers to share in the profits or losses. Moreover, as noted above, the use of a consumer dividend leads to a similar result, but as an immediately lowered rate in the current period rather than as a "give back" in the next. The logic is somewhat different, however: a consumer dividend implies "we know how much your costs increased, but we want you to work harder to lower costs and earn a profit," while profit sharing is more "if you earn a profit over a certain return, you have to share it with consumers." Because electric utilities are in an earlier stage of restructuring than the telecommunications industry, and perhaps because of industry fears of possible losses, there is more discussion of profit sharing associated with incentive or price cap plans.[2]

Setting the initial cap

Where to set the initial rate that will be capped is not as straightforward as it may appear. The easiest solution is simply to use the current rate. However, rates may not have been reset in many years; consequently, they may not reflect the current costs of the firm for the particular class of service where the cap will be applied. Another option is to have a "last rate case" to set the cap (as proposed in H.R. 22). Ideally, the cap would be set to reflect the cost of providing that service. However, the difficultly for utility rate setting is that existing rates often contain either explicit or implicit subsidies that cross customer classes, such as urban to rural or long-distance or toll to local (certainly there are such splits that apply to postal rates as well). The difficultly comes about because these class subsidies have existed for decades and a sudden elimination of them would result in a "rate shock." Making the change is politically difficult as

[2]Currently, the issue of incentive rates in the electric supply industry is taking a back seat to the many issues surrounding the development of a competitive generation market.

well, since a large number of people may see their rates go up. To soften the impact, a phased-in approach can be used that gradually phases out the subsidy and restructures the rates. As an indication of the difficultly involved, it should be noted that it has taken years just to address the issue and it has by no means been solved completely in most jurisdictions. With no real competitive pressure the old rate structures could remain. The motivation for change now is that the widening of competition means lower prices for many of the services that are a major source of revenue. The temptation by the regulated companies is to shift costs to customers with the fewest alternatives. This completely reverses the historical rate structures under regulation. Many of these factors are what is behind the current "rate rebalancing" in the telecommunications industry.

Quality of service

There is mounting evidence that quality of service may deteriorate under a price cap plan if preventative steps are not taken. The apparent reason for this is that, in the drive to cut costs, an easy way to do it is for the company to cut staff and other expenses related to customer service. Some states have seen a deterioration in service quality and have either instituted or are considering instituting quality standards with monitoring. If quality falls below the standards set, then penalties are imposed on the company. Currently, sixteen states have price cap plans with penalties for quality of service degradation. Given the current evidence, it appears to be advisable to at least monitor service quality. This issue is discussed in the context of postal regulation in the next section.

APPLICATION OF PRICE CAP REGULATION TO THE POSTAL SERVICE

A regulatory dilemma: monitoring cost or quality

Regulators appear to face a dilemma when deciding whether to stay with cost of service regulation or switch to price cap regulation. That is, by switching to a price cap plan they improve the incentive to control costs, and consumer prices may decrease over time, but to achieve lower costs the firm may decrease service quality. In short, the same drive to improve the incentive to lower costs may create an incentive to cut quality standards. This is clearly a

manifestation of the fact that, in certain markets, firms simply do not face significant competition. In a competitive market, customers can choose based on price, quality, and many other factors (depending on the product). Many markets often have different levels of quality for customers to choose from. This is not a problem because its the customer's choice. Price caps work best with some level of competition in the market. Of course, if there was significant competition then there would be no need for price caps and the market could be deregulated completely.[3] A competitive market can monitor costs, prices, and quality better than any regulator can, but it simply may not be feasible to have a completely competitive market.

This is the same dilemma that you face right now with respect to Postal Service regulation. If competition is not considered an option for those services classified as noncompetitive services, then the question may be, which is easier to monitor quality or costs? In general, it is probably easier for the regulator to monitor service quality than costs. This is because quality is more readily observable than cost. The major limitations of cost of service regulation were related to the difficultly of measuring and monitoring costs. If it is true for the Postal Service that quality is easier to monitor, then price cap regulation probably does offer a superior alternative to cost of service regulation. Of course, measuring quality will require a different operating procedure by the regulator, but there already are mechanisms to measure service quality of the Postal Service. These may need to be altered or increased, however, if price caps are applied.

Price cap regulation is based on a profit motive

As a financially independent government agency with rates set by the Postal Rate Commission, the Postal Service is similar to a regulated utility. However, there is at least one significant difference, a private regulated utility has stockholders to whom it must pay dividends to and be accountable for growth and profit. The Postal Service's management must also be

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[3] Price caps could also be used as a transition tool to deregulation when it is uncertain whether the market is sufficiently competitive. By observing that the actual price charged customers is significantly and consistently below the cap, it could be inferred that the market is competitive.

accountable, of course, but its motives are clearly different. A private, regulated and for profit firm is motivated by the need to lower costs under a price cap plan, since it has the potential to earn a return on its investments, and the harder it works the more potential gain to the company. On the other side of rewarding with profits is penalizing when, for example, there is deteriorated service quality, as discussed above. For the same reason, penalties would also have a diminished impact when applied to the Postal Service. At the extreme, all competitive firms face what is sometimes called "risk of enterprise," that is, the possibility of being driven out of business. Regulated firms usually do not face complete receivership, but bankruptcy is not unknown, and the consequences for the management can be severe. However, subsection 3723(f) of H.R. 22 allows a change to the adjustment factor when needed "to restore the Postal Service to fiscal soundness." I am not suggesting that this be taken out of the bill (I understand that it is there for a different reason), only that consideration be given to the rather limited impact that incentives and penalties will likely have on the Postal Service.

A possible solution to this problem may be to reward employees based on the Postal Service's performance. Subsection 3783(e) of H.R. 22 has a provision for bonuses to be paid to officers and employees of the Postal Service, under certain conditions, from any profit earned. However, a more extensive system such as profit sharing (perhaps a base salary plus, when earned, a bonus) with all employees and noncash rewards such as tuition credits may strengthen the incentives. Such a program should be widespread and significant enough to be appreciated. Of course, penalties for decreased quality of service should be felt by management in some way as well (perhaps reducing bonus compensation down to the base salary).

In conclusion, price cap regulation has been a success in that it has resulted in lower prices and costs and higher productivity. The problem of deteriorating service quality can be mitigated by monitoring the firm and, if there is a deterioration, penalizing it. There appears to be an opportunity for the use of price caps in regulating the Postal Service. However, more extensive modifications may have to be made to the current reward structure to induce the desired behavior, namely, careful control of costs. In addition, it is probably advisable to have increased monitoring of service quality and penalties that are appropriate and fair, but that also

have the effect of maintaining the Postal Service's high quality standards to which the citizenry is accustomed.

ATTACHMENT
State Telecommunication Company Price Cap Plans
April 9, 1997

State	Year plan in effect	Inflat-ion Index	Adjust-ment (%)	Revenue profit sharing	Service Quality Penalty	Length of freeze on basic svcs	Length of plan	Infra-structure Invest-ment
AL	1995	GDPPI	3.0	No	Yes - up to .8% addition to adjustment factor	5	No limit	No
AK	None							
AZ	None							
AR	1997	GDPPI	15% of current rates or .75% GDPPI	No	No	3	No limit	No
CA	1994	GDPPI	5.0	Yes	No	4	3	No
CO	1993	GDPPI	up to 5.0	Yes	Yes	5	5	No
CT	1996	GDPPI	5.0	No	Yes	2	No limit	No Info
DE	1994	GNPPI	3.0	No	No	2	4	250M by 1998
DC	1996	GDPPI	3.0	No	No	4	No limit	4M to ed infrastruc ture
FL	1995	GDPPI	1.0	Yes, to 1998	No	6	No limit	No
GA	1995	GDPPI	3.0	No	No	5	No limit	2 billion by 2000
HI	None							
ID	None							

State	Year plan in effect	Inflat-ion Index	Adjust-ment (%)	Revenue profit sharing	Service Quality Penalty	Length of freeze on basic svcs	Length of plan	Infra-structure Invest-ment
IL	1995	GDPPI	4.3	No	Yes, up to 2.0	4	4	3 billion by 2000
IN	1994 Caps	None	None	No	No	4	4	150M by 1999
IA	1995	GDPPI	2.6	No	No	3	No limit	Com-pany specific
KS	1990 Freez e	None	None	No	No	7	7 (re-newed after 5)	160M first 5, up to 64M yr next 2
KY	1995	GDPPI	4.0	No	No	Frozen pending universl svc reform	No limit	No
LA	1996	GDPPI	2.5	No	Yes	5	No limit	No
ME	1995	GDPPI	4.5	No	Yes	No	5	No
MD	1996	GDPPI	3 yr avg CPI	No	No	4	No limit	No
MA	1995	GDPPI	4.1	No	Yes	6	6	No
MI	1995	CPI	2	No	No	No	No limit	No
MN	1996	None	None	No	Yes	3	Com-pany specific	Com-pany specific
MS	1996 Freez e	None	None	No	Yes	3	4	Yes but company specific

State	Year plan in effect	Inflat-ion Index	Adjust-ment (%)	Revenue profit sharing	Service Quality Penalty	Length of freeze on basic svcs	Length of plan	Infra-structure Invest-ment
MO	1994 Freez e	None	None	No	No	4	4	275M for 4 yrs
MT	None							
NE	1987	None Deregu lation	None	No	No	None	No limit	None
NV	1995 Caps	None	None	No	Yes	5	5	Com-pany specific
NH	None							
NJ	1993	GNPPI	2.0	Yes	Yes	6	6	1Billion+ by 1999
NM	None							
NY	1995	GDPPI	4.0	No	Yes	4	4	150M Yr
NC	1996	GDPPI	2.0	No	No	3	No limit	None
ND	1993	41.67% of GNPPI or annual % change in GNPPI-2.75%		No	No	None	No limit	None
OH	1996	GDPPI	3.0	No	Yes	4	4	18M over 4 yr
OK	None							
OR	None							
PA	1994	GDPPI	2.93	No	No	5	5	Univer-sal broad-band by 2015

State	Year plan in effect	Inflat-ion Index	Adjust-ment (%)	Revenue profit sharing	Service Quality Penalty	Length of freeze on basic svcs	Length of plan	Infra-structure Invest-ment
RI	1996	CPI	Lesser of CPI or 5%	No	Yes	None	5	No
SC	1996	GDPPI	2	No	No	4	No limit	No
SD	1996 Caps	None	None	No	Yes	3	No limit	No
TN	1995	GDPPI	Lesser of .5 GDPPI or GDPPI-2%	No	No	4	No limit	No
TX	1995	CPI	Set by PUC	No	No	4	No limit	Yes - digital upgrades by 2000
UT	None							
VT	None							
VA	1995	GDPPI	.5 of GDPPI	No	No	6	No limit	No
WA	None							
WV	1995	CPI	None	No	No	3	3	350M over 5 yr
WI	1994	GDPPI	3	No	No	3	5	700M over 5 yr
WY	1996 Caps	None	None	No	Yes	No	No limit	No

Sources: State Telephone Regulation Report, March 20, 1997, pp.1-9, Vol. 15, No.6 and April 3, 1997, pp.1-8, Vol. 15, No. 7 and conversations with selected commission staff, April 1-4, 1997.

Mr. MCHUGH. Next we have Dr. Joel Popkin. Sir, welcome.

STATEMENT OF JOEL POPKIN, PRESIDENT, JOEL POPKIN AND CO.

Mr. POPKIN. Thank you, Mr. Chairman, and I appreciate the invitation to appear before you and the members of the committee today.

My testimony has essentially two parts. The first part is presentation of the background against which this legislation is being considered, the economics of the Postal Service at present, so to speak. And the second part has to do with specific details of H.R. 22. I would say, on average, looking at the data available from the Government and other sources, the performance of the Postal Service since its reorganization in 1971 has been a little bit better than that of the average U.S. private business. And that's even more remarkable, I think, when account is taken of the fact that the Postal Service has the obligation to provide universal service at uniform rates. So I think the Postal Service, as these charts will demonstrate, has been functioning quite well.

The first chart shows the price performance of the Postal Service. You can see the price of all postal services, the BLS number, shows it at all times below the Consumer Price Index. The thing that always strikes me about that is I am not sure that should be the standard. The Postal Service is a service industry, and I think the standard ought to be the CPI for consumer services, and as you can see, that's gone up quite a bit faster than the price of postage.

The next chart takes a look at the wage performance of the Postal Service. The top line is the employment cost index for private nonfarm workers. The lower line is the rate of pay for a level 5, step 0 postal worker. Your typical postal worker is in level 5, step 0, and you can see that postal wages, looks like since about 1981, have lagged behind private sector wages in general.

Can we have the next chart, please?

Now, here is another measure of wage performance. This takes a look at the pay structure of the Postal Service; it takes account of step promotions and changes in the number of steps in each grade and takes a look at the average amount of straight time hourly pay the Postal Service pays its employees. And you can see that that lags even further behind the employment cost index for private sector workers. On average, the pay of postal—the real pay, inflation-adjusted pay of postal workers has declined at an average annual rate of five-tenths of 1 percent over the period of time we are looking at.

The next thing is the productivity of the postal workers. Here we have private nonfarm unit labor costs. That's wages minus productivity. And for the private sector, you have the blue line, for the APWU bargaining unit using BLS measure of output, a pink line. You can see that those unit labor costs have gone up less than the private economy, and in fact, if you just use pieces of mail, a cruder measure, not as sophisticated as the BLS measure, you can see that the average unit labor costs have fallen even further behind those of the private nonfarm sector.

Now, if all these things are true, some good things must be happening to the Postal Service, and in fact I think the next charts

show that. This is the—these are the major industries that comprise the U.S. communication and transportation sectors. I have the revenue growth rate, their volume growth rate, and their price rate over the last 10 years. And you can see that the Postal Service's revenue has grown at an average annual rate of 6.5 percent.

Now, all of these sectors' growth rates have grown at an average annual rate of 5.5 percent, so in fact the Postal Service has grown faster in terms of market share than the average, which means and the next chart will demonstrate—you can see the Postal Service, which is the sort of purple one—just below the white one, I think that the—I can't read those increases, but there certainly is an increase of at least a percentage point in market share among communication and transportation sectors of the economy.

Now, a lot of the success of the Postal Service comes from the fact that its business is—an important part of its business is advertising driven, and the next table shows advertising driven revenues. As you can see cable TV is the leader, 17.1 percent average annual rate of increase, and I guess that will jump up even more given the most recent increases that cable TV have announced that they are going to charge the consumer.

The Postal Service revenues in the advertising field have really grown second, more than magazines, more than TV, more than radio, well above the 5.1 percent average annual rate of all advertising driven communications business. This is not a bad performance, and if you go to the next chart, you will see how that looks on a pie chart.

As I recall, that's a 3 percentage point increase in market share in the advertising business. So I want to—I feel comfortable drawing the conclusion that the Postal Service is really doing quite well, and with that I want to turn to some of the aspects of H.R. 22 that I think are appropriate for discussion today.

The first thing, and since that table is on the easel, let me call to your attention the difference in the labor intensity of the different industries that have, some of which have been mentioned and will be mentioned in subsequent testimony by other panelists.

We have the telephone industry, for example, an industry where price caps are being used more extensively. The labor costs in the telephone industry are 24 percent of total costs. That means other costs make up 76 percent. Radio broadcasting, 42 percent labor costs. The health services, 51 percent of revenues in health services go to labor. In the Postal Service, 80 percent of total revenue goes to labor.

And the conclusion I draw from this is that price caps in an industry that's as labor intensive as the Postal Service is tantamount to wage caps. There's no other way, there's no more flex in the system. It's either jobs or wages. There's no give. In telephone, there's give. There are changes in capital investment strategies and that sort of thing. In the Postal Service, there's no give.

The other point I want to make has to do with some of the tradeoffs that the bill proposes would be made in order to let the Postal Service have more flexibility in what's called the competitive part of H.R. 22. The point I want to make here is that I am not so sure that the pro competitive parts of this bill are necessarily worth some of the things that the Postal Service and the consumer have

to give up to achieve them. And in particular, as a homeowner, I can tell you that I really don't want to invite more traffic up to the mailbox that's in the carport in my home. I don't want ununiformed people accessing my property.

Now, different people may feel differently about that, but it's hard enough to keep track of all the people that come onto your property, and I for one am concerned about the proliferation of people who have access to the front doors and mailboxes of homes.

So I think there are two aspects here of the provisions of H.R. 22 that I want to, that I have tried to draw attention to. I think that I have demonstrated today using official Government and advertising trade data that the USPS is a quite healthy business, despite having to cope with more than its share of market impacts from technological impacts.

Postal market shares are growing, particularly in advertising; postal wages have risen less than other private sector wages; APWU labor productivity has risen faster than the total private economy for; and postal rates have risen about as fast as the CPI and less than the CPI for services. There is really no need to alter the regulatory environment of the USPS. In fact, the proposed alterations may do both business mailers and consumers more harm than good.

Thank you, Mr. Chairman.

Mr. MCHUGH. Thank you, Dr. Popkin.

[The prepared statement of Mr. Popkin follows:]

Prepared Statement
of
DR. JOEL POPKIN
Joel Popkin and Company, Washington, DC

Before the

Subcommittee on the Postal Service
United States House of Representatives
April 16, 1997

I appreciate the invitation to testify this morning on HR22, a bill to reform the postal laws of the United States. But it is not at all clear these laws need reform. On average, the performance of the Postal Service, since its reorganization in 1971, has been a little better than the U.S. private nonfarm economy as a whole. That is even more impressive considering the legislative mandate of the USPS—to provide universal service at uniform rates.

The first evidence of its rather remarkable performance is that stamp prices have gone up almost in line with inflation as measured by the Consumer Price Index (CPI). Chart 1 demonstrates that since reorganization, the BLS price index for postal services has risen at an annual rate of 5.3 percent. During the same period, the CPI rose at an annual rate of 5.1 percent. But the benchmark for postal services ought not to be the total CPI but rather the CPI for services because the USPS is a service industry--like transportation and communications. The CPI for services, also shown in Chart 1, rose at an annual rate of 6.4 percent during the same period.

The price performance of the USPS can be viewed in another way. The price of a first class stamp as of February 1997, adjusted for inflation, was the same eight cents it was just after postal reform went into effect in 1971. According to the March issues of the journal, *Mail*, taxpayers had been subsidizing another two cents worth of postal costs out of general tax revenues. So the price in 1971 was really 10 cents. Additionally, the Congress, through Omnibus Budget Reconciliation Acts over the past ten years, has shifted another one cent of costs for postal retirees from

taxpayers. Thus, the correct conclusion in terms of resource utilization is that in real terms the price of a first class stamp has fallen from ten cents in 1971 to less than eight cents in 1997.[1]

Business mailers have fared even better. From 1978 to last July when rate reclassification went into effect, the postal service, with the PRC's blessing if not insistence, gave business mailers about two cents more discount per piece of mail than they were entitled to on "cost-avoidance" grounds. Thus, the real price of first class mail sent by the business sector fell even more than mail sent by households because the USPS and PRC subsidized the contracting out of work formerly done by postal workers.

And speaking about postal workers, what about their wages and compensation? The record is found in Charts 2 and 3, which begin in September 1975 when the employment cost index was first calculated. Private nonfarm sector wages and salaries rose at an average annual rate of 5.0 percent. As can be seen in Chart 2, the wages of a level 5, step 0, APWU employee rose at a somewhat slower annual rate of 4.7 percent. APWU workers' average straight-time hourly wages, a measure that takes into account all developments in the postal pay scale, rose at a rate of 4.5 percent (Chart 3). Postal wages have lagged the private economy. Adjusted for inflation by the CPI, real wages at level 5, step 0, have declined at an annual rate of 0.5 percent. So wages do not seem to be a problem for the U.S. rate payer.

Is productivity performance the problem? Chart 4 shows the behavior of unit labor costs since 1977, the year the USPS changed its national payroll-summary data definitions to those in use today. The chart shows that while unit labor costs for the APWU bargaining unit rose 3.8 percent per year on average during 1977-96, unit labor costs for the private nonfarm economy rose 4.4 percent, 0.6 percent faster. If APWU productivity is measured by pieces of mail, the APWU

[1]Other cost shifting proposals in this bill (Title V, Section 501) and others in Congress would probably push this real rate to seven cents, or prematurely prompt a rate increase.

unit labor costs rise even slower, 2.5 percent per year. Again USPS workers' performance exceeds that of the U.S. private economy at large.

These results suggest that the USPS should have done very well in the quest, critical to every business, for increased market shares. The data in Chart 5 show it did. During the last decade, USPS revenues have grown 6.5 percent per year. When that is compared with its major communications and transportation industry competitors, it is almost as fast as revenue growth in trucking and airlines; only the cable TV industry grew much faster than all three. The average revenue growth for all major transportation and communications competitors was 5.5 percent. The faster, 6.5 percent USPS growth translates to a gain, not a loss, in USPS market share based on latest available data. Clearly, the wage and productivity performance of the postal service has benefited the USPS' bottom line—the mailing public. The USPS market share in these industries grew from 6.9 percent in 1986 to 7.6 percent in 1996 (Chart 6).

Chart 5 shows volume growth as well. USPS ranks fifth among the ten industries. Its volume growth rate—2.1 percent per year—has not lagged that far below telephone service growth of 3.6 percent. That is surprising in view of the fact that telephone growth reflects that of electronic communications, including additional phone lines.

The postal service is an important communications network for advertisers. That its importance is growing can be seen from Chart 7. Postal service growth in advertising-driven revenue is second only to cable TV. Revenue growth for each is well above the 5.1 percent annual average for advertising communications services. As can be seen in Chart 8, the USPS share of the communication media that advertisers use has grown. And the USPS volume growth makes clear the growing preference of advertisers for "targetable" direct mail over TV, magazines, radios, and newspapers. That preference also reflects advertisers' reaction to the relatively slow rise in postal wages and unit labor costs.

Despite these facts, which demonstrate the USPS has operated within the bounds of its means, special interests have been keeping up the pressure on policy makers to restructure the postal service. Their strategy is to attack on two fronts. The first is to argue that the postal service will become obsolete because of the growth of electronic communications. The second is that postal employees' wages are too high. These arguments are made despite the favorable market share and volume growth comparison in Charts 5 through 8 between the USPS and the telephone industry, which are indicators of the need for hard copy communications despite growth in electronic usages. And the same special interest pleading clearly must ignore the data in Charts 2 and 3 that show postal wage increases have lagged those for the average, private worker.

HR22 appears to accept these special interest arguments by proposing two main tools: (1) open part of the postal service to competition in exchange for freedom from price setting by the PRC, and (2) subject the remainder of postal revenue to price caps.

On the first issue, electronic communication, we must face up to the fact that no one can hold back technological change. There is clearly no wage rate at which letters, even expedited ones, can compete with e-mail. Many other industries, not just the USPS, face this competition. Fax transmission is being diverted to e-mail, affecting the telephone industry. The Internet competes with TV and the publishing industry. Yet, despite this competitive threat, postal volume growth has held up well vis-a-vis its historic relationship with real GDP, when account is taken of the slowdown in household formation, a major factor in generating new addresses.

HR22 seems to seek to deal with competition from new technology by giving the USPS more freedom to compete by setting its own prices on a subset of mail. But it should be recognized that such competition is only for the existing hard copy market and will not stem the shift to electronic communication.

The dubious benefit of the procompetitive part of this bill is paid for in different ways, such as the mailbox demonstration project. As a homeowner, I do not want to invite more traffic up

to the door where my mail box is located. Ununiformed individuals should not be allowed access to privately-owned residences for any, but the most vital reasons and certainly not to deliver advertising. But the more important problem with such initiatives is that they will undermine the concept and provision of universal service. The nation values universal service at uniform rates. That is why these principles are reflected in recommendations regarding the Internet and may be endorsed by the FCC.

The most onerous, yet unnecessary, provision of HR22 is its price cap provision. The bill is one that calls for the use of the Gross Domestic Product Price Index (GDPPI) to set the limit by which the bulk of postal rates can rise. One reason noted for putting price caps in the bill is its use in public utility and telecommunications regulation. But those industries are characterized as capital intensive industries in contrast with the USPS, which along with the medical care industry, are our most labor-intensive large industries. The labor intensity of various industries, some regulated, some not, are shown in Table 1.

A price cap in a labor intensive industry is effectively a wage cap. Enactment of such a cap would impinge on the collective bargaining process, and ultimately make employees pay for mismanagement. And it would be used as a device to deny postal workers increases in living standards enjoyed by workers in the private economy. In this manner, HR22 would return USPS labor relations to the state which existed prior to reorganization, a situation which no one should be interested in resurrecting.

In an earlier discussion, it was shown that postage rates have declined in real terms. The price cap criterion has been met historically. It would appear to be unnecessary regulation. However, the price cap has a gimmick—it is called an adjustment factor. And in the example demonstrating its use, it is illustrated by a subtraction from the inflation index (GDPPI). In other approaches this Committee has received, including one from the Postal Service (letter of October 1, 1996 from PMG Runyon to Chairman McHugh), the adjustment factor has been termed a "stretch" factor. The word stretch is euphemistic for wage constraint. The "stretch" factor underscores what

seems like the fundamental objective of HR22—to keep postal rate increases well under overall inflation. Such an objective can only realistically be met by forcing real wage losses on the working people of the postal system. This is clearly an unfair intrusion on the market, but one that would undo the efficiencies the USPS and its employees have achieved since postal reorganization in serving the American people.

I think I have demonstrated today, using official government and advertising trade data, that the USPS is a quite healthy business despite having to cope with more than its share of market impacts from technological advances. Postal market shares are growing, particularly, in advertising. Postal wages have risen less than other private sector wages, APWU productivity has risen faster than economy-wide labor productivity, and postage rates have risen about as fast as the CPI and less than the CPI for services. There is really no need to alter the regulatory environment of the USPS. In fact, the proposed alterations may do both business mailers and consumers more harm than good.

DISCLOSURE STATEMENT

The only contract with an agency of the Federal Government received by Joel Popkin and Company during the Fiscal Year ended September 30, 1996, was one awarded by the Committee for Purchase from People Who Are Blind Or Severely Disabled in the amount of $21,044. In addition Joel Popkin and Company did work on five contracts awarded by various government agencies prior to that fiscal year, but we do not understand that House Rule XI requires details as to such previously awarded contracts.

During the Fiscal Year ended September 30, 1996, Joel Popkin and Company served as a consultant to the American Postal Workers Union (APWU), primarily in labor interest arbitration proceedings in which APWU was involved. It is our understanding that APWU does not have contracts with any government agency.

Chart 1: Producer Price Index for All Postal Services
Compared to the All Items CPI and the CPI for Services

(January 1972=100)

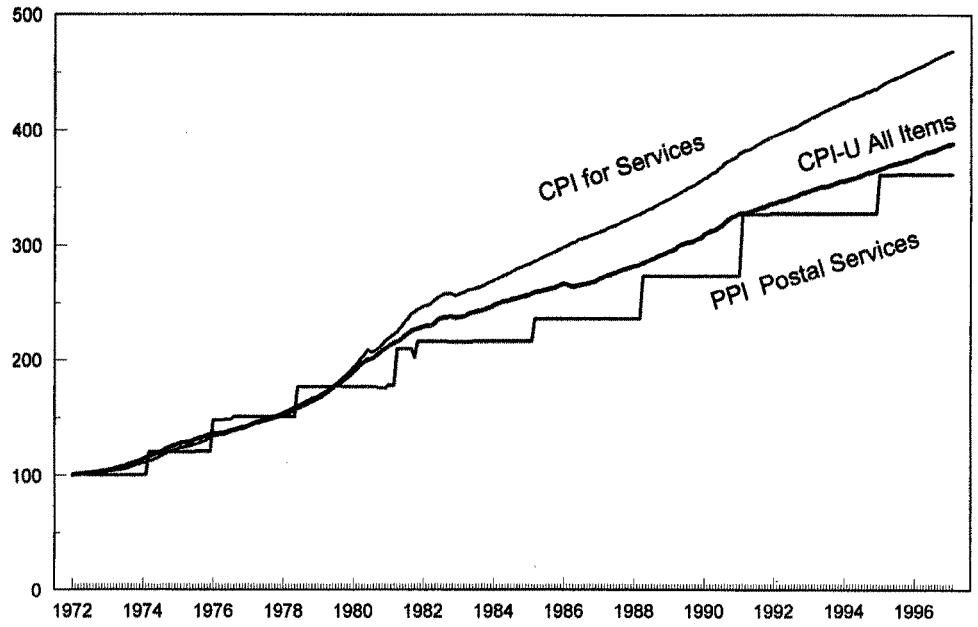


Chart 2: ECI for Wages and Salaries of Private Nonfarm Workers
Compared with the Wages of the Level 5 Step O Postal Worker

September 1975 = 100

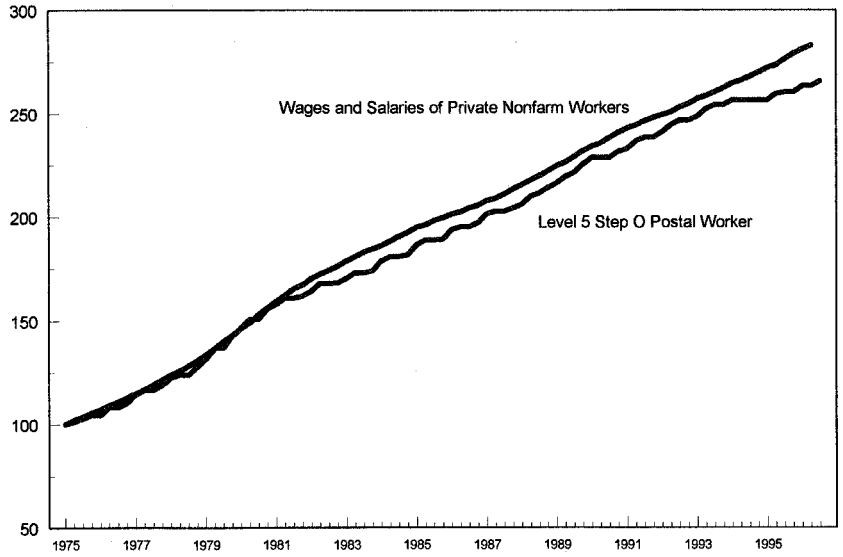


Chart 3: ECI Private Nonfarm Workers Compared to Straight Time Hourly Wage of the APWU Bargaining Unit

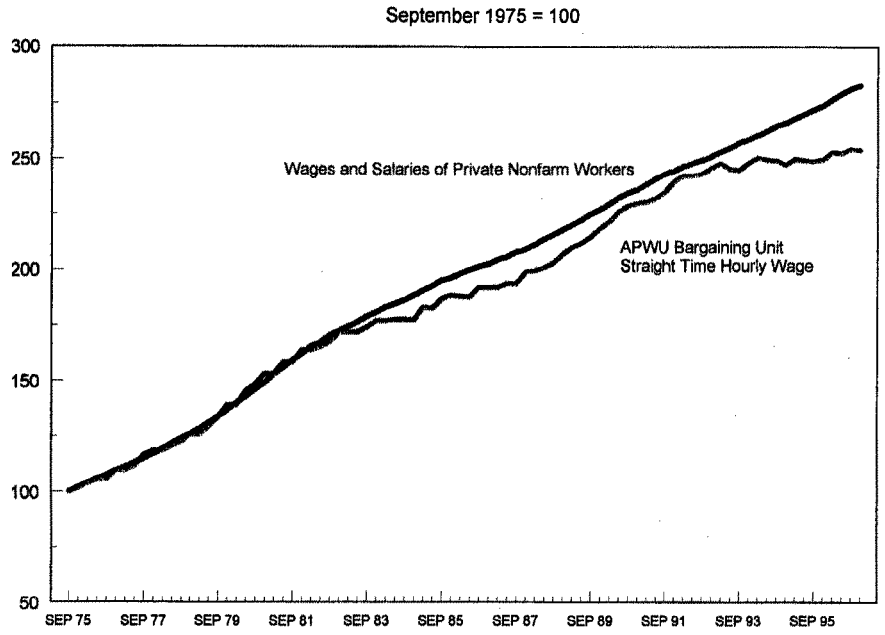


Chart 4: Unit Labor Costs - APWU Bargaining Unit Compared with US..
Private Nonfarm Workers

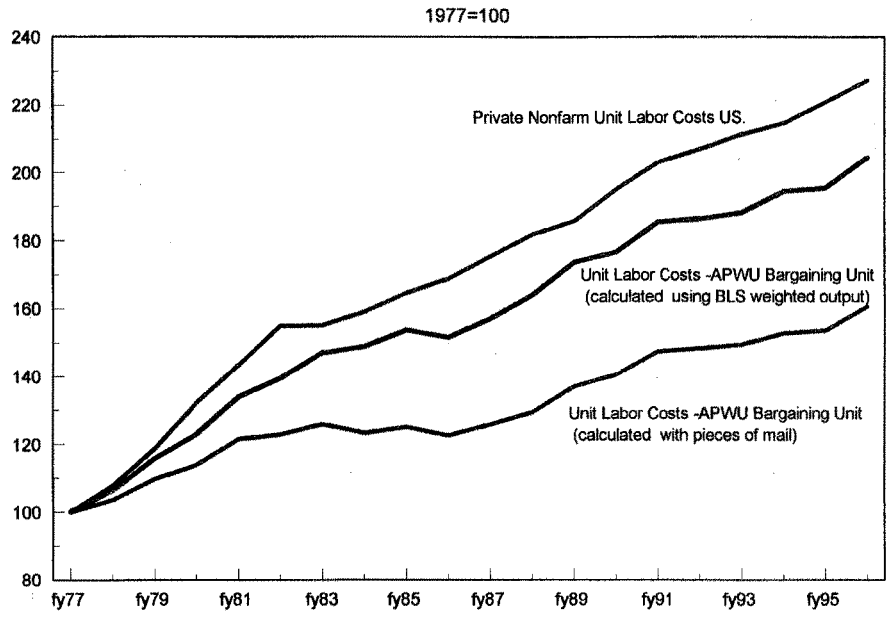
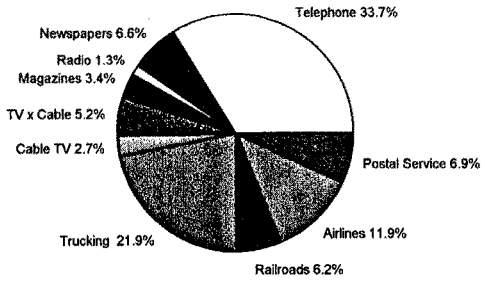


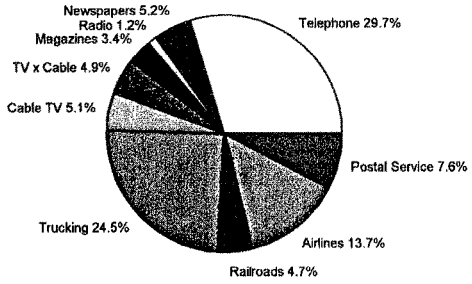
Chart 5: Communication and Transportation Sectors
Ranked by Revenue Growth
(Average annual percentage growth, 1986-1996)

Sector	Revenues	Volume	Price
Cable TV	12.5	6.1	6.0
Airlines	7.0	2.5	4.5
Trucking	6.7	5.6	1.1
Postal Service	6.5	2.1	4.3
Magazines	5.3	1.0	4.4
TV excluding Cable	4.8	1.4	3.4
Radio	4.7	0.3	4.4
Telephone	4.1	3.6	0.6
Newspapers	3.0	-2.7	5.9
Railroads excluding Amtrak	2.5	1.5	1.0
All Sectors	5.5		

Chart 6: Relative Market Shares of the Major Communication and Transportation Sectors of the Economy



1986



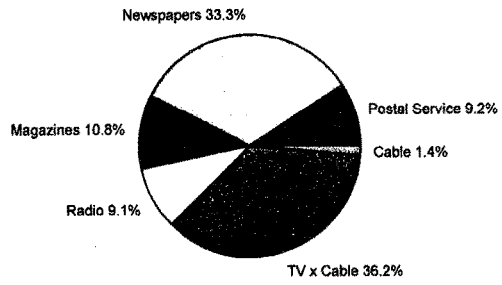
1996

Chart 7: Communication Sector Revenues Driven by Advertising

(Average annual percentage growth, 1986-1996)

Sector	Revenues	Volume	Price
Cable TV	17.1	10.3	6.2
Postal Service	8.1	2.1	5.9
Magazines	5.9	0.9	5.0
TV excluding Cable	4.8	1.4	3.4
Radio	4.7	0.3	4.4
Newspapers	3.3	-2.7	6.2
All Sectors	5.1		

Chart 8: Relative Advertising Revenue Shares of the Major Communications Sectors



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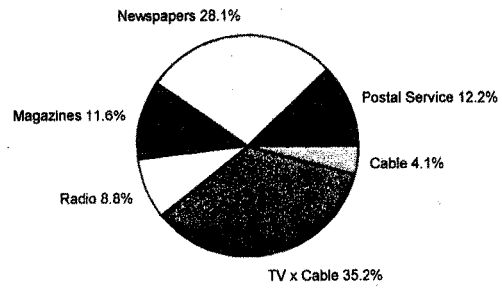

1996

Table 1: Compensation's Percent of Industry Revenues

Industry	Compensation's Share of Industry Revenues
Cable Television	17
Television Broadcasting x Cable	24
Telephone	24
Radio Broadcasting	42
Legal Services	46
Computer and Data Processing	47
Engineering, Architectural, Accounting Services	49
Health Services	51
Postal Service	80

Mr. MCHUGH. Next, Mr. Gregory Sidak, who as I mentioned is resident scholar at the American Enterprise Institute. Sir, thank you for being here. We look forward to your comments.

STATEMENT OF GREGORY SIDAK, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Mr. SIDAK. Thank you, Mr. Chairman.

I would like to say a few words about price caps and relate those remarks to the scope of the Postal Service's statutory monopoly and also the application of the antitrust laws to the Postal Service.

I have three main points to make with respect to price caps. First is one that came up earlier this morning, and that is that the Postal Service is a not-for-profit enterprise. So we have to be very careful about making inferences about how price caps would work in that nonprofit context, because all of our experience with price caps really relates to for-profit, private companies that have a shareholder constituency. The Postal Service is not currently a profit maximizer. That's partly by statute because of the regulatory constraint that is currently in the law; the Postal Service, as a consequence, is not subject to the same forces that a private shareholder-owned company is for its management to try to minimize costs and maximize profit.

Section 3783(e) of the bill would attempt to create the opportunity for bonuses to be paid to Postal Service employees and officers to try to replicate some of the incentives that exist inside a private firm. But I don't think those provisions will go far enough to replicating what private enterprise is able to do in terms of creating incentives for profit-maximizing, cost-minimizing behavior. The provisions also invite the question that if Congress believes that replicating the incentives that exist within private enterprise would be a good thing for the Postal Service, why not go the whole way and privatize the enterprise? I don't believe that's on the table right now, so that leaves us to ask how well will the current proposal work in terms of increasing the efficiency of the Postal Service.

The second point about the price caps, is that it's important not to lose the forest for the trees here. We should not dive into a technical debate on how best to measure productivity or how best adjust for exogenous changes in cost, and lose sight of the fact that price caps may not work very well for the reasons I just described because we are trying to apply them to a nonprofit-maximizing enterprise.

A related point concerns the capital-labor ratios of the Postal Service. If 80 percent of its total current costs are labor, that does not necessarily tell us that that is the cost-minimizing capital-labor ratio. We would want to compare that ratio to private firms that are providing comparable kinds of services.

A final point relating to price caps is benchmarking. Currently, one of the advantages of price-cap regulation on a State-by-State basis is that one State can look to what's going on in another State. If a local exchange carrier in Ohio has substantially higher costs than in Pennsylvania, the regulatory commissions in those two States can compare notes. The National Association of Regulatory

Commissions [NARVC] is capable of exchanging that information on behalf of its commissions.

Now, if price caps are, in effect, an alternative to competition a way to come up with better regulation and if they are not likely to work as well in the not-for-profit sector as in the for-profit sector, why don't we consider the real thing? Why don't we consider instilling more competition in the marketplace here?

So that leads to the question of the statutory monopoly that the Postal Service currently enjoys.

There are two kinds of monopolies. One is the Private Express Statutes, and the other is the monopoly over the customer's mailbox. Let me say a few words about the Private Express Statutes and why I think that more could be done in H.R. 22 to address the monopoly.

The monopoly covers the term "letter." It also covers "packets," which is now an archaic term. The Postal Service in turn has power to define the scope of that key term of art, "letter." So in that sense, the Postal Service has the ability to define the scope of its own monopoly. This is unlike any kind of regulation of monopoly that we see in other industries where public utility commissions regulate privately owned firms that are providing utility services.

In addition, the Private Express Statutes appear in the U.S. Criminal Code. They are criminal prohibitions. The doctrine of vagueness in constitutional law says that, as a matter of due process, a statute is void and unenforceable if persons "of common intelligence must necessarily guess at its meaning and differ as to its application." If we are coming up with extremely complicated definitions of what a letter is, definitions that may be counterintuitive to many people of common intelligence, that strongly counsels Congress to provide definition try to come up with and to give the authority for flushing out that definition to some neutral body other than the Postal Service, the recipient of the monopoly privilege.

Let me say a word now about the mailbox monopoly. This provision also is in the criminal code, 18 U.S.C., Section 1725.

I think there are three significant economic consequences of the mailbox monopoly. First, it enables the Postal Service to raise the cost of its rivals of making a delivery to its customers. In antitrust law there's a theory called "raising rivals cost," and this is an example of that.

Second, it deters integration by businesses such as banks or utilities, which would have large numbers of mailings going to virtually every postal customer on a given route. It's telling that the mailbox monopoly was not enacted at the same time that the Private Express Statutes were enacted in the 1840's. It was enacted in 1934, specifically to counteract vertical integration by these kinds of businesses into the delivery of monthly bills.

The third point about the mailbox monopoly is that it imposes a cost on the customer as well, in terms of substituting alternative delivery services for the Postal Service because the customer would have to build a new receptacle to house the deliveries of a private delivery service.

I think that the demonstration projects that are proposed in section 704 of H.R. 22 are a good idea, but I think Congress can go much farther. I think where we should go is down the road of open

access, much as has taken place in natural gas transmission, wheel of power, and open access in local telephony. The mailbox can be thought of as the customer premise equipment of the postal network. In the early 1980's, the FCC deregulated customer premise equipment. The result was a proliferation of new kinds of telephones and answering machines and the like, lower prices, and higher product variety.

The security question that came up a minute ago is a valid consideration. One way to deal with that is to require that any private carrier that would have access to a customer's mailbox be licensed and bonded. We could require be uniformed to facilitate their identification by the customer.

Let me say a word about the antitrust laws. H.R. 22 would extend the antitrust laws explicitly to the Postal Service in section 3744, with respect to the competitive categories of mail and the experimental products that are described in the bill. It's important to work through the statutory analysis, though, because that may not result in extending the antitrust laws quite as far as it might seem at first examination.

A second point is, why not extend antitrust scrutiny to all services of the Postal Service, including letter mail? In this respect it's useful to compare the closest communications industry, the telephony industry. The Bell System was opened up to competition not through regulatory action but through an antitrust case in which the former AT&T monopoly vigorously attempted to defend itself on the grounds that it was regulated by State and Federal commissions and should be exempt from the antitrust laws. Judge Harold Greene rejected that argument, and I think rightly so. The antitrust laws were applied even to a statutory monopoly. Were that not the case, we probably would not have had the divestiture of the Bell System in the way that occurred.

Let me just conclude by saying that my preferred approach is what I call "commercialization" of the Postal Service. It's something that I describe at length in the book that Professor Spulber and I have written. Basically, it would entail repealing the Private Express Statutes, the mailbox monopoly, and other statutory privileges, but it would also relieve the Postal Service of what we call "incumbent burdens," including its unique responsibilities for providing universal service. That's not to say universal service would end. But it would be funded through a different mechanism than embedding it in the structure of the mail. All services of the Postal Service would then be subject to antitrust oversight.

Now, if we couldn't do the commercialization option, I think that what we are left with is really stricter public oversight of the Postal Service, which would mean a more vigorous, invasive role for the Postal Rate Commission. We would have to consider seriously the option that the mandate review in Canada has proposed, which would be to require the Postal Service to exit markets that are demonstrably competitive. We would have to explicitly subject the Postal Service to the antitrust laws. Thank you.

Mr. MCHUGH. Thank you. Well, it's good to know we all agree.

[The prepared statement of Mr. Sidak follows:]

BEFORE THE
SUBCOMMITTEE ON THE POSTAL SERVICE
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT
UNITED STATES HOUSE OF REPRESENTATIVES

HEARINGS ON H.R. 22, THE POSTAL REFORM ACT OF 1997

TESTIMONY OF J. GREGORY SIDAK

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Thank you, Mr. Chairman, for inviting me to share with the Subcommittee my views on H.R. 22, the Postal Reform Act of 1997. I am appearing today in my individual capacity and not on behalf of the American Enterprise Institute, which does not take institutional positions on individual pieces of legislation, or on behalf of the Yale School of Management or any interested company. In the interest of full disclosure, I wish to note that in the past I have consulted to United Parcel Service and in 1995 submitted a report to this Subcommittee on the company's behalf concerning the Postal Service's proposal to employ inverse-elasticity pricing. In addition, last year I submitted a report on behalf of the Canadian Competition Bureau in the Mandate Review of Canada Post Corporation.

The Subcommittee has requested my views on three topics: price caps, the scope of the Postal Service's statutory monopoly, and the application of the antitrust laws to the Postal Service. My views on each subject are discussed at length in two publications of mine, which I have submitted for the record for the Subcommittee's convenience. The first and most exhaustive is my book with Professor Daniel F. Spulber, entitled *Protecting Competition from the Postal Monopoly* (AEI Press 1996). In that book the Subcommittee will find complete references to the statutory and regulatory provisions discussed in this testimony. The second publication, which applies the same analysis to the Canadian marketplace, is a recently published article with Professor Spulber, "Monopoly and the Mandate of Canada Post," 14 *Yale Journal on Regulation* 1 (1997). I also submit a book of edited papers, *Governing the Postal Service* (AEI Press 1994), in which a variety of scholars in law and economics address the relationship between the

PRICE CAPS

There are several serious, perhaps insoluble, problems with the attempt in H.R. 22 to impose price caps on the Postal Service. First, and most important, the bill presumes that prices caps will work when they are applied to a not-for-profit enterprise having no effective shareholder constituency. The statutory requirement of revenue adequacy in the Postal Reorganization Act currently does not envision operating the Postal Service on a for-profit basis. Moreover, the managers of the Postal Service do not currently appear to be profit maximizers; indeed, it is unclear what they are attempting to maximize—volume of pieces of mail, revenues, assets, number of employees, or something else. Consequently, it is doubtful that price caps could work for the Postal Service. The driving force that produces consumer benefits when price caps are applied to a privately owned firm—the firm's incentive to minimize costs and thereby increase profits—would be absent if price caps were applied to the Postal Service. One therefore would not expect the Postal Service to respond in the same manner as a privately owned utility to the economic incentives that price caps present. Although H.R. 22 would take measures, in proposed section 3783(e), to simulate the incentive structure of a for-profit firm by making Postal Service officers and employees eligible for bonuses, those measures fall short of the incentive structures that result from private ownership and the market for corporate control. Indeed, if Congress thinks that it would be socially beneficial for the Postal Service to reinvent itself so as to replicate the workings of a privately owned, profit-maximizing enterprise, why not simply privatize the venture and rely on the superior ability of the marketplace to impose incentives for profit-maximizing, cost-minimizing behavior?

Given this fundamental problem of matching incentives and regulatory instruments, it follows with even greater force that Congress's consideration of price caps for the Postal Service should not focus on a technical debate about how best to measure total factor productivity and adjustments for exogenous events. But if the Subcommittee *does* choose to engage in that debate, a second problem with price caps emerges. Some argue that, because roughly 80 percent of the Postal Service's total costs currently are labor, the appropriate price index to use to compute a price cap for the Postal Service is one that tracks changes in prices in labor-intensive service industries. That reasoning, however, is flawed because it presumes that the current capital-labor ratio for the Postal Service is cost-minimizing. Given the diffuse, public ownership of the Postal Service and its current mandate to break even (not to maximize profit), it would be surprising if the Postal Service's existing capital-labor ratio were cost-minimizing. In other words, inefficient combinations of capital and labor in the Postal Service's operations should not provide the basis for skewing the targeted level of growth in factor productivity under a price cap that Congress might adopt for the Postal Service.

A third reason to doubt the efficacy of price caps for the Postal Service concerns benchmarking. When one state's public utilities commission imposes a price cap on a regulated utility, there can be as many as 49 other state jurisdictions to use for comparison purposes. With multiple benchmarks, the reasonableness of the starting price level is more subject to check, as is the reasonableness of declines in that price over time. A price cap for the Postal Service, however, would lack that advantage, because the firm would be national in scope and would be regulated by a single federal regulatory body. International comparisons would be inherently less reliable than state-by-state comparisons because there would be so many other political, economic, and social factors that could not be held constant across countries.

THE SCOPE OF THE POSTAL SERVICE'S STATUTORY MONOPOLY

A major shortcoming of H.R. 22 is its failure to end the Postal Service's statutory monopolies. Given the infrequency of major postal reform legislation, that aspect of H.R. 22, if not corrected, would constitute a lost opportunity of substantial proportions.

The Postal Service currently enjoys two kinds of statutory monopolies. The first category encompasses restrictions on the delivery of letters under the Private Express Statutes. The second is the monopoly over use of the customer's mailbox.

A. *Private Express Statutes*

The postal monopoly is a combination of statutory law and regulation encompassing "letters" and the archaic and now-irrelevant term "packets." The definition of "letters" consequently is critical to understanding the extent to which the letter segments of first class and third class mail are closed to competition. The Postal Service defines a letter to be "a message directed to a specific person or address and recorded in or on a tangible object," although that definition is subject to a multitude of qualifications and caveats. The result is unlike that in any other regulated industry: Because the Postal Service claims for itself the term "letter," which defines the extent of its monopoly, the monopolist has the power largely to define the scope of its own monopoly.

What is perhaps most notable about the Private Express Statutes is that their key provisions appear in the United States Criminal Code. Apart from all else that it is, the postal monopoly is the threat of criminal punishment. Section 1694 of Title 18 forbids the carriage of matter out of mail over post routes. An analogous provision, section 1695, forbids the carriage of matter out of mail on vessels and adds the threat of imprisonment. Likewise, section 1693 makes the collection, receipt, or carriage of mail in contravention of the Private Express Statutes punishable by both fine and imprisonment. A more seriously punishable crime than the mere carriage of matter out of mail is the creation of a private express network capable of competing with the Postal Service. While sections 1693, 1694, and 1695 take aim at the labor and transportation inputs that would be directly used to provide competitive delivery of letters, section 1696 addresses the deployment of capital and managerial labor to establish a private express network.

The most significant exception to the Private Express Statutes (technically termed a "suspension" of the Statutes by the Postal Service) is for "extremely urgent letters." Without that exception, Federal Express, United Parcel Service, and other private firms would be unable to compete in the express mail business. It bears emphasis, however, that the exception for extremely urgent letters is one that the Postal Service itself defines. To enforce the Private Express Statutes, the Postal Service has used its powers of search and seizure against large mailers in both the private and public sectors. In a highly publicized incident in 1993, armed postal inspectors arrived at the Atlanta headquarters of Equifax Inc., a large credit reporting company, and demanded to know whether all the mail that it had sent by Federal Express was truly urgent, as required by the Postal Service's suspension of the Private Express Statutes for extremely urgent letters. Equifax agreed to pay the Postal Service a penalty of $30,000, which the *Los Angeles Times* described as "essentially a fee allowing the firm to use Federal Express as it wished for the following year without Postal Service harassment."

As I have explained earlier to this Subcommittee, and as Professor Spulber and I show in our book, the statutory monopoly of the Private Express Statutes can lead to erroneous conclusions by the Postal Service concerning what inverse-elasticity pricing should imply for the price of letter mail. The net effect of that error is to produce prices for captive customers that would exceed the prices that would maximize consumer welfare. That ramification of the Private Express Statutes takes on great significance under H.R. 22 because the bill would establish, under new section 3701(c), that demand elasticity shall be the second-highest consideration in ratemaking, after attribution of direct and indirect costs. H.R. 22 does nothing to debunk the fallacy that prices to letter mail customers should be high because they are captive to a statutory monopoly. Demand elasticity also may be considered under new section 3723 when price adjustments are made under the proposed price cap.

It is incumbent on Congress to give a clear statutory definition of a "letter" that the Postal Service does not have the power to change at will. The Private Express Statutes are, after all, criminal prohibitions. Yet the statutes themselves do not provide a clear definition of what is a "letter" that private express carriers may not deliver. Instead, the public postal monopoly provides the definition. H.R. 22 would not correct the situation satisfactorily. It would permit, in section 703 of the bill, a letter to be carried outside the mail if it is priced at $2.00 or above or if the Postal Service already permitted it to be so carried. The problem, however, lies in those postal products that the Postal Service concludes, for obscure and self-serving reasons, *are* "letters." H.R. 22 does not restrain the Postal Service's ability to dictate that certain kinds of lucrative services priced below $2.00 are still treated as "letters" even if consumers would never consider them to be letters. As a matter of due process, a statute is void on its face due to vagueness if persons "of common intelligence must necessarily guess at its meaning and differ as to its application." *Connally* v. *General Construction Co.*, 269 U.S. 385, 391 (1926). It is surely questionable whether persons of common intelligence could correctly identify what is and is not a "letter" under the Postal Service's arbitrary regulations defining the scope of its own monopoly.

B. *Customer Mailbox Monopoly*

The mailbox is to the postal monopoly what the customer's telephone was to the former Bell System. The mailbox is the customer premises equipment. Just as the Bell System assiduously fought, starting with the *Hush-A-Phone* case, any attempt by the customer to attach unapproved devices to his telephone (which is to say, devices not manufactured by the Bell System's own Western Electric), so also the Postal Service regulates what the customer may do with his own mailbox. The Postal Service's behavior is actually more overreaching than that of the monolithic Bell System in its heyday because the mailbox is clearly the customer's private property, whereas before the AT&T divestiture the customer merely leased his telephone from the Bell System.

Section 1725 of the U.S. Criminal Code prohibits the deposit of unstamped "mailable matter" in a customer letterbox approved by the Postal Service. Violations are subject to a fine. In turn, the *Domestic Mail Manual*, which is incorporated by reference into Title 39 of the Code of Federal Regulations, specifies the size, shape, and dimensions of mail receptacles. The Postal Service requires that letterboxes and other receptacles designated for the delivery of mail "shall be used *exclusively* for matter which bears postage."

The Postal Service's monopoly over mailbox access has three significant economic consequences. First, it enables the Postal Service to raise the cost of its rivals' deliveries: Federal Express or United Parcel Service, for example, may not leave its overnight letter in the mailbox if the recipient is not home.

Unless the sender designates that the urgent letter may be left at the door if the recipient is not there, the carrier will have to attempt another delivery. A second and related consequence is to deter vertical integration into mail delivery by businesses (such as banks and utilities) with large numbers of routine mailings to virtually every postal customer on a given route. It is telling that Congress did not enact section 1725 in 1845 as part of the original Private Express Statutes, but rather in 1934 to counteract vertical integration by such businesses into the delivery of bills. The third competitive consequence of section 1725 is that it raises the cost to the customer of substituting alternative delivery services for those of the Postal Service because his reliance on the former will require him to construct a new receptacle for private express deliveries.

The provision in H.R. 22 to conduct demonstration projects of open access to customer mailboxes, proposed section 704, is far too timid. The Subcommittee should be setting its sights higher by ordering open-access deregulation of the customer mailbox--just as the Federal Communications Commission in the 1980s opened the market for customer premises equipment to competition, and just as Congress and federal regulators have ordered open-access for natural gas transportation, wholesale wheeling of electric power, and local exchange telecommunications. Congress could easily address concerns about security by requiring that any private carrier seeking access to customer mailboxes be licensed and bonded.

Congress should seriously consider an additional, constitutional reason for repealing section 1725. Although the prohibition on competitive use of the customer mailbox was unsuccessfully challenged on First Amendment grounds, it apparently has never been challenged as an uncompensated taking of private property. The statute can be viewed as effecting both a regulatory taking and a physical invasion of private property. Although the federal government may be entitled to demand exclusive use of the customer's mailbox, it hardly follows that the government is exempt from paying compensation to property owner for demanding exclusive use of his property as a condition of delivering mail to him.

C. *Summary*

The Private Express Statutes and the customer mailbox monopoly are truly extraordinary in the history of American regulation of industry in the manner in which they grant and perpetuate monopoly power. The Postal Service does not passively reap the benefits of a monopoly conferred upon it by Congress. To the contrary, the Postal Service enjoys the power to expand the boundaries of that monopoly through the promulgation of its own regulations; the power to prosecute alleged violations of the monopoly through its own searches and seizures and its own enforcement actions for postage due; and the power to adjudicate alleged violations of the monopoly. In short, the Postal Service simultaneously exercises legislative, prosecutorial, and adjudicatory functions to circumscribe the private delivery of mail. Even at its apex, the Bell System could never take such liberties with the welfare of American consumers. It would be inexcusable for Congress to purport to enact postal "reform" legislation that neglected to repeal these statutory monopolies.

APPLICATION OF THE ANTITRUST LAWS TO THE POSTAL SERVICE

In its current form, H.R. 22 would subject the Postal Service, through proposed section 3744, to antitrust scrutiny with respect to "competitive" categories of mail and "experimental" products. That provision is good as far as it goes. But it stops short of extending antitrust scrutiny to all of the Postal

Service's products, including letter mail. It bears emphasis that the Bell System, which had monopoly franchises for local exchange service in many states, was broken up not as the result of a state or federal regulatory proceeding, but rather an antitrust prosecution. Statutory monopoly did not shield Bell's local exchange operations from antitrust scrutiny. It is not clear why Congress should want to prevent the antitrust laws, which are intended to protect consumer welfare, from applying to those postal products for which consumers will have the fewest competitive alternatives.

The statutory monopolies and other statutory privileges and immunities are not the only grounds for concern about possible anticompetitive conduct by the Postal Service. The usual economic refutation of the plausibility of predatory pricing by private firms does not hold in the case of the Postal Service. Economists (and courts) reason that a private firm is unlikely to attempt predatory pricing because it must be able to recoup current losses with extraordinary returns in the future (after the rival has been driven from market). But the Postal Service is a not privately owned firm that is accountable to shareholders, and it has the ability to borrow from the Treasury despite incurring repeated operating losses. Accordingly, the Postal Service has shown that it is capable of incurring losses year after year. Thus, unlike a private firm attempting predatory pricing, the Postal Service could incur current losses while underpricing rivals without really worrying about ever recouping those losses. The Postal Service's potential to engage in predatory pricing is therefore more threatening than that of a private firm. In the language of economics, the Postal Service can make threats of predation that are more credible than those of privately owned firms.

WHAT SHOULD CONGRESS DO?

If privatization of the Postal Service is not on the table, then the policy most conducive to greater economic welfare is one of commercialization of the Postal Service. Such a reform package would repeal the Private Express Statutes and other statutory privileges enjoyed by the Postal Service, explicitly subject the Postal Service to the antitrust laws and all other laws of general applicability to private businesses, and relieve the Postal Service of its incumbent burdens, including the duty to deliver at a uniform national rate to high-cost areas. The Postal Rate Commission would oversee the transition to competition and then cease to exist. This set of reforms might eventually lead to the privatization of the Postal Service, though it need not. Indeed, privatization would be unconscionable on economic grounds if it failed to provide for repeal of the Private Express Statutes.

If, on the other hand, Congress declines to commercialize the Postal Service, its remaining option will be considerably more invasive. The Postal Service's continued enjoyment of statutory privileges will necessitate much greater oversight of the Postal Service by the Postal Rate Commission, the Postal Service's divestiture of operations in demonstrably competitive lines of business, and close antitrust oversight to ensure that the Postal Service does not abuse its lawful monopoly over letter mail.

The least acceptable course of action is for Congress to continue to do nothing in the face of the Postal Service's expanding empire. The Postmaster General's observation that the Postal Service could become a profit center for the federal government is an admission that it is time for Congress to protect competition from the postal monopoly.

A. *A Blueprint for Commercialization*

A public enterprise can be commercialized even if it is never privatized. A plan for the

commercialization of the Postal Service should include three main elements: removal of statutory entry barriers and other privileges, relief from incumbent burdens, and explicit antitrust oversight.

1. *Repeal the Private Express Statutes and Other Statutory Privileges*

The Subcommittee should amend H.R. 22 to repeal the Private Express Statutes. The general rule in the American economy is that attempted monopolization is a crime, but when it comes to delivering letters it is attempted competition that is the crime. If the Postal Service wishes to compete on the merits with private firms, it should not be allowed to do so behind the protection of a statutory monopoly.

The Subcommittee should also amend H.R. 22 to repeal the statute that creates the Postal Service's monopoly over access to the customer's mailbox. The repeal of legal restrictions on access to mailboxes by competitors of the Postal Service would properly treat the customer's mailbox as the private property that it is. The deregulation of mailbox access would increase competition across various existing and future classes of mail by lowering costs for competitors of the Postal Service and lowering the consumer's cost of switching from the Postal Service to a private express firm. Open access to the customer's mailbox would permit the development of innovative features, as has occurred with the deregulation of customer premises equipment in telecommunications. Eliminating that small but widespread entry barrier would facilitate competitive services and increase customer convenience.

More generally, the Subcommittee should amend H.R. 22 to specify that, for as long as the Postal Service remains publicly owned, it shall be subject to all laws generally applicable to private firms and shall have no special privileges or immunities arising from its public ownership. It is fine for H.R. 22 to contain specific provisions in this respect, but it is far more important for the bill to announce the general principle that the Postal Service shall not have a preferred status among firms competing in the marketplace. The Postal Service should be subject to all of the antitrust, employment, environmental, securities, tax, and other laws with which any private company must comply. The Postal Service should not be allowed to borrow from the Treasury, nor should its debt be backed by the full faith and credit of the U.S. government.

2. *Relieve the Postal Service of Its Universal Service Obligation and Other Incumbent Burdens*

If the Postal Service is to be stripped of its unique statutory privileges as a condition of being allowed to compete freely against private firms, it should also be relieved of its unique statutory obligations. The most conspicuous of those obligations is the universal provision of mail delivery at a uniform price. There are other incumbent burdens, such as law enforcement responsibilities relating to mail fraud, which should be transferred to other parts of the federal government.

There is a powerful efficiency-based argument for removing the incumbent burdens of the Postal Service, an argument distinct from concerns about symmetry or fairness. As a matter of political economy, it would be easier to repeal the Private Express Statutes and to remove the other barriers to competition in postal services if Congress were simultaneously to remove the putative justification for those special privileges. Because universal service is the most prominent of the Postal Service's incumbent burdens, it is also the Postal Service's last line of defense of the Private Express Statutes.

From the perspective of maximizing consumer welfare, of course, it would be regrettable if the

commitment to providing mail service to rural and other high-cost segments of the population were to have the effect of denying *all* segments of the population the substantial benefits that would flow from having multiple providers of letter mail service rather than only one provider. There is also a jurisprudential argument against funding universal service or other incumbent burdens through the creation of artificial monopolies. The cross-subsidies in postal rates are an implicit regime of taxes and appropriations. Taxing and spending is properly the role of Congress under Article I of the Constitution. Congress should not delegate those decisions to the Postal Rate Commission and the Postal Service—neither of which has any direct political accountability to the electorate. The magnitude of the subsidy to rural recipients of mail should be apparent from an explicit line item in the budget; it should not be an amount that can be inferred only by undertaking extensive economic analysis of the cross-subsidies effected by the monopoly over letter mail.

Despite the repeated efforts of scholars to convey those messages in a variety of regulated industries, including postal delivery, rate structures containing cross-subsidies have endured in such industries. If one hopes to influence public policy in the real world, it is therefore necessary to take account of how actual political constituencies and institutions may prevent the achievement of reforms that would increase economic welfare. By enacting legislation to fund universal postal service in a way that does not depend on the artificial creation of a monopoly, Congress would deny opponents of postal commercialization their most politically effective argument for not repealing the Private Express Statutes and the Postal Service's other special privileges.

There are at least two general means by which Congress could decouple universal service from the Private Express Statutes. First, Congress could send postal subsidies directly to consumers in rural areas. Those subsidies could even be means-tested, if one's low income were considered to be more important than one's rural address. Those customers would then be billed directly by the carrier of last resort for the high cost of what might be called "terminating access," to borrow a telecommunications concept. The lower basic stamp price that would result would not include the surcharge for delivery to costly, remote areas. A second means would be for the government to solicit bids from private firms to deliver mail to remote areas for a specified contract term. The winning bid would be that which proposed to provide service at the lowest subsidy from the government. If Congress were to adopt either approach, it could end the false rhetoric that American consumers must tolerate a monopoly to have universal service.

3. *Subject All Services of the Postal Service to Explicit Antitrust Oversight*

The Postal Service's history of suppressing competition in letter mail, and its use in 1993 and 1994 of its search and seizure powers to dissuade large business customers from using Federal Express for mail that the Postal Service did not regard as "extremely urgent," suggest that competition would not come naturally to this public enterprise. In its current form, however, the Postal Rate Commission is not up to the task of regulating the Postal Service in a manner that would protect its efficient private competitors. It is a recognized danger that an industry-specific regulator will become captured by the companies it regulates. The Postal Rate Commission faces this risk with three additional handicaps. First, it is not merely an industry-specific regulator, but a firm-specific one. Even in the days of the Bell System, the Federal Communications Commission's agenda was not dictated by AT&T alone. Second, the Postal Service in effect has by statute the right to disregard the Postal Rate Commission's decisions. Third, the Postal Rate Commission is fundamentally a ratemaking body expert in mediating issues of revenue adequacy and fairness across classes of customers, not an antitrust enforcer expert in measuring

competition and assessing the effect of strategic behavior on consumer welfare.

Congress should therefore explicitly subject all of the Postal Service's services to the antitrust laws and to the competitive oversight of the Antitrust Division of the Department of Justice and the Federal Trade Commission. Those agencies have expertise in competitive analysis. Furthermore, they have independence because they enforce statutes that apply to all industries. Finally, the Antitrust Division in particular has special experience in dealing with antitrust problems concerning regulated network industries bearing some similarity to the postal industry, such as telecommunications.

B. *Stricter Public Oversight*

If commercialization of the Postal Service is not politically feasible along the lines just described, then Congress should substantially increase public oversight of the Postal Service. That option contains four necessary elements. One is to enlarge the powers of the Postal Rate Commission and make it truly an independent body. The second is to disabuse the Postal Service of any notion that its mission is to earn "profit" for the federal government. The third is strictly to limit the lines of business in which the Postal Service may operate. The fourth is to subject the Postal Service to explicit antitrust oversight to ensure that it does not abuse its continuing privileges under the Private Express Statutes and other laws.

1. *Strengthen the Postal Rate Commission*

If the Private Express Statutes remain and the Postal Service retains its other statutory privileges as a public enterprise, then Congress must give the Postal Rate Commission the same powers and credibility that agencies such as the Federal Communications Commission and the Federal Energy Regulatory Commission have with respect to the private firms that they regulate. At a minimum, such legislation would have to eliminate the Postal Service's ability to overrule the rate recommendations of the Postal Rate Commission. In addition, the Postal Rate Commission would need to have the authority to impose its own accounting standards on the Postal Service, to require the Postal Service's routine reporting of reliable cost data, and to order whatever structural relief (such as divestiture of operating units, separate subsidiaries, accounting separations, and so forth) it deemed necessary to regulate the Postal Service in a manner that advanced the purposes of public provision of postal services.

2. *Clarify That It Is Not the Postal Service's Mission to Be a "Profit Center" for the Federal Government*

If the Postal Service is not commercialized, Congress should reject the Postmaster General's call to make the Postal Service a "profit center" for the federal government. Even taken at face value, that proposed mission is especially questionable in light of the many reasons that exist to conclude that the Postal Service currently does not act as a profit maximizer. Economic theory does not justify public enterprise on the ground that the government can make a profit competing against private firms. The government's source of funds is better confined to its taxation of the private economic activity of firms and households.

3. *Remove the Postal Service from Markets That Are Demonstrably Competitive*

In any market where private firms already provide adequate mail services, there is no need for the Postal Service. Congress should remove the Postal Service by statute from any such market, or

delegate such removal power to the Postal Rate Commission, for no market failure is present that could justify government intervention, let alone intervention in the extreme form of a publicly owned enterprise. The antitrust laws are sufficient to ensure that postal markets that are demonstrably competitive today will not be monopolized or cartelized by private firms when the Postal Service exits the field. The Mandate Review of Canada Post Corporation has made such a recommendation.

4. *Explicitly Subject Abuses of the Private Express Statutes to the Antitrust Laws*

Even if Congress declined to repeal the Private Express Statutes, there would still be a role for review of the Postal Service by the Antitrust Division or the Federal Trade Commission. Such review would determine whether the Postal Service was abusing its lawful monopoly over letter mail to reduce competition in markets for other services. In principle, this role for the antitrust agencies would resemble the Antitrust Division's frequent examination under the former Modification of Final Judgment of whether a particular regional Bell operating company was using its local exchange bottleneck to reduce competition in a different product market. That form of antitrust oversight would be the natural complement to an order by the Postal Rate Commission removing the Postal Service from demonstrably competitive markets.

CONCLUSION

If privatization is not a viable option, then the path to more competitive and innovative mail service in the United States is the commercialization of the Postal Service. Such a reform package would repeal the Private Express Statutes and other statutory privileges enjoyed by the Postal Service, explicitly subject all of the Postal Service's services to the antitrust laws and all other laws of general applicability to private businesses, and relieve the Postal Service of its incumbent burdens, including the duty to deliver at a uniform national rate to high-cost areas. The Postal Rate Commission would oversee the transition to competition and then cease to exist. This set of reforms might eventually lead to the privatization of the Postal Service, though it need not. Indeed, privatization would be unconscionable on economic grounds if it failed to provide for repeal of the Private Express Statutes.

If, on the other hand, Congress declines to commercialize the Postal Service, its necessary alternative will be considerably more invasive. The Postal Service's continued enjoyment of statutory privileges will necessitate much greater oversight of the Postal Service by the Postal Rate Commission, the Postal Service's divestiture of operations in demonstrably competitive lines of business, and close antitrust oversight to ensure that the Postal Service does not abuse its lawful monopoly over letter mail.

Mr. MCHUGH. Our last two presenters, as I understand it, have decided to really split their time. This is not an unusual position for they have written any number of books and articles together, so we are very pleased that they are able to appear here together this morning. According to the high sign I got, we will begin with Professor Michael Crew first.

Thank you both for being here, and professors, we are awaiting your comments.

STATEMENT OF MICHAEL CREW, ECONOMICS PROFESSOR, RUTGERS UNIVERSITY

Mr. CREW. Thank you, Mr. Chairman, for inviting us to testify. We do intend to stick to our time, and we have powerful incentives to do so, because as professors we are doing something rather unusual today, we are teaching, and we have to get back.

This is indeed a crucial issue that faces the U.S. Postal Service and the Congress, the question of legislation and reform right now. What I am going to do is begin by emphasizing the contexts in which our proposal should be understood, and then Dr. Kleindorfer is going to highlight some of the principal changes that really should be considered in revising H.R. 22.

The current state of postal and delivery services presents Congress and the Postal Service with some difficult choices. The situation has arisen primarily because of exogenous changes, chiefly including the technological change in microelectronics, optical fiber, and computer-based alternatives, such as the Internet, which are revolutionizing traditional communications and advertising.

In our experience with international conferences with postal delivery services since the early 1990's, we have noticed there's been a strong interest worldwide in reforming the postal service, so this remains an important sector in the communications marketplace and not an albatross around the neck of National Government.

In order to remain viable, postal administrations have been moving to a more businesslike approach to postal service and to the incorporation of regulatory innovations such as incentive regulation. H.R. 22 recognizes this mandate and the dangers of not heeding it. The problem is that H.R. 22 does not fully recognize the seriousness of the current situation, and incorporate the major changes required.

For the good intentions of H.R. 22 to bear fruit, two major changes must be incorporated in any postal reform legislation. One, the Postal Service should cease to be a public enterprise. The new law should call for its privatization. Two, the labor relations framework for a privatized Postal Service should be that of a private company with the right to strike and lock out, and not subject to binding arbitration as presently.

H.R. 22 proposes incentive regulation, specifically price cap regulation. It comes as no surprise that the U.K.'s adoption of price caps regulation for its newly privatized industries are generally cited as a major success story. Price cap in the U.K. was successful because the industries concerned were privatized. For price cap regulation to succeed, there must be residual requirements and the dissolution of the capital markets, including bankruptcy. By being more efficient, the private company under a price cap can make ad-

ditional profits just like any unregulated private company and use these to motivate management to make further profits and increase the value of the shareholders' investment. It is the existence of residual claimants that drives the efficiency promised by price cap regulation. Absent residual claimants, these potential efficiency benefits will not be achieved.

If all that is added to the current mix of public ownership and binding arbitration is price cap regulation, it's not clear what benefits, if any, will ensue. Indeed, it may make matters worse. Additional profits might be arguably counterproductive under the present system and might simply send a signal to arbitrators that the Postal Service could pay more.

Without privatization and changed labor relations, reforms envisioned in H.R. 22, or almost any other adoption of price cap regulation would do little or nothing to improve the status quo. Indeed, the result may be much worse than the current situation in that it would create false hopes and further delay the implementation of needed reforms.

For all these reasons, the specifics of price cap regulation now to be identified by my colleague, Dr. Kleindorfer, should be conditional on concurrent privatization and reform of labor relations.

Thank you again, Mr. Chairman, and committee members. I'd like to now hand over the baton to my colleague.

Mr. MCHUGH. Dr. Kleindorfer, our attention is yours. Thank you for being here.

STATEMENT OF PAUL KLEINDORFER, ECONOMICS PROFESSOR, UNIVERSITY OF PENNSYLVANIA

Mr. KLEINDORFER. Thank you, Mr. Chairman, committee members, ladies and gentlemen. I'd like to address a few comments to the details of H.R. 22 and specifically to its approach to the implementation of price caps.

In the spirit of Dr. Crew's comments, my remarks are not meant to provide a detailed prescription, but rather only an outline of key points, all of which are intended to reinforce two central ingredients of reform and we believe also are the intent of H.R. 22.

First, the Postal Service should be given the opportunity and flexibility to compete and to evolve, and second, the Postal Service should be given the incentive to do so. In this regard, H.R. 22 has a number of problems in the structure of the price cap which it proposes. It also has a number of good points, but I am going to try to be constructive here and I will focus on only the problems, Mr. Chairman.

Our concerns are with the structure of baskets and with the uniform applicability of adjustment factors within a basket. Both of these directly affect the issue of flexibility of the Postal Service to compete and to innovate.

Except as specified in subsection 3724, no individual price within any basket is allowed to increase by more than the price index which is specified in H.R. 22 as the GDP price index less X. This contrasts with the more common arrangement where the prices in the basket are aggregated into an index which is allowed to increase—the index, that is—by GDP minus X.

Under H.R. 22, since price reductions wouldn't count, there would be very little incentive not to increase the price by less than the maximum allowed. Thus, the potential for adjustments within the baskets over time would be minimal, which would fail to provide flexibility and opportunities for change normally allowed in price gap regulation.

The solution? Use the standard price gap index approach to ensure pricing flexibility within baskets.

Another concern is the actual structure of the baskets. H.R. 22 provides for four baskets which comprise the vast majority of the revenue of the Postal Service, including some products which should be considered competitive.

Too many mail products are considered monopoly type products when they are subject increasingly to competition. The result of this is to fail to provide the flexibility that the Postal Service needs to compete and evolve.

The solution? Our approach to the definition of "baskets" concentrates on those parts of the market where the Postal Service has monopoly power. Thus, we propose price regulation should apply only to monopoly services and not to a wide class of products. Services provided would be, in our proposal, divided into two groups, regulated and nonregulated. The regulated basket would, however, consist of only those services where there is monopoly power. Price gap regulation would apply only to the regulated basket. All other services would be in its unregulated basket.

The price cap index that we would envisage would also be rather simple. The regulator would set the price of the basic, single piece, First Class postage, both domestic and international, the price of access to the local delivery network and the price of special services and services mandated by Congress, such as material for the blind and Certified Mail.

The Postal Service would be free to raise rates by the rate of index minus X formula over the period of the price gap. The Postal Service would be allowed to set all other prices, the unregulated basket, without regulation.

It is important to note that the Postal Service, when subject to price gap regulation, would not have the incentive to cross-subsidize its unregulated operations as it might under cost-of-service regulation.

Although the Postal Service would have considerable latitude under this proposal in pricing, for example, its bar code and other bulk mail operation, it would still be subject to certain constraints. For example, its regulated access price would represent a floor below which it would not be able to set its price for its other services, so the rate for both Bar-Coded Mail could not be set below the rate for access.

Similarly, the ceiling price that it would be allowed to charge would be the price gap on single piece, First Class Mail. Between the floor and the ceiling, for work sharing and discounts and other issues of this sort, the Postal Service would be free to set its prices for its unregulated products. In addition, a privatized Postal Service would, of course, be subject to the full force of the antitrust laws, just like any other private company.

Other aspects of our proposal are spelled out in more detail in our testimony, including quality issues, initialization, and so forth. I won't go into these here.

While our proposals represent a significant change in postal regulation, they are consistent with current practice in other industries. Our proposals are also consistent with H.R. 22 in providing protection against monopoly exploitation in any regulatory Government structure through the PRC for resolving disputes.

A central issue which our proposal attempts to address is to provide a framework which encourages the Postal Service to innovate and to evolve in the face of market changes. Things may be good now, ladies and gentlemen, but in all places and all parts of the world we are seeing, based on sophisticated econometric modeling, real challenges that are going to erode this rosy picture soon unless we also have a competitive, evolving, and adaptable Postal Service.

The more flexible basket definitions we have proposed and the use of indexing within the regulated basket provide significant increases in opportunities and incentives for product innovation relative to the current version of H.R. 22, which essentially maintains rigid line of business restrictions as currently embodied in reclassification procedures.

Conclusions: Absent major changes, the Postal Service will not be able to survive in its present form. There will be major reductions in employment levels and large reductions in mail volume, not perhaps in the next year or two, but soon.

H.R. 22 is important in recognizing the need for change and proposing incentive regulation, but it doesn't address the problem adequately. In our view, what is needed is a two-pronged approach, spearheaded by privatization of the Postal Service, or at least a time line for privatization of the Postal Service, and reform of labor relations practices, together with an approach to incentive regulation, such as envisioned here, which focuses on those aspects of postal delivery service which need to be regulated, leaving others to be regulated by the force of competition.

[The prepared statement of Mr. Kleindorfer and Mr. Crew follows:]

Postal Service in Transition: H.R. 22 - The Postal Reform Act of 1997

The U.S. Postal Service and Postal Regulation have worked reasonably well for over 20 years. However, because of technological progress, regulatory innovations, and increasing competition, the time is now ripe for major reform, and H.R. 22 is one of several legislative initiatives worldwide which recognize the importance of such changes. The purpose of this testimony is to examine some of the forces that are currently affecting postal service and their implications for postal reform, including some specific comments on H.R. 22. We provide only the basic outline of our proposals here, since to do otherwise would extend well beyond the length appropriate to this occasion. However, we note some references to the growing body of research on postal policy upon which our proposals are based.

1. The Current State of Postal Service

The Postal Reorganization Act of 1970 provided the basis for the current organization of the U.S. Postal Service and the Postal Rate Commission. This organization has had numerous successes during the last quarter of a century. The regulatory process has emphasized procedural fairness, allowing competitors and mailers a strong voice in the setting of rates and the shaping of new services. Despite the apparent cumbersome, legalistic structure of this regulatory process, it has not stifled innovation. USPS is a world leader in volume of mail, work-sharing discounts, bulk mail, automation, and downstream access. In addition, the rates for basic First-Class mail are amongst the lowest in the advanced economies.

Although the system has been successful in many respects, postal service in the United States cannot continue in its present form because of a number of shortcomings in the existing system. These shortcomings have surfaced because of major exogenous changes that are not compatible with the current system. These changes include chiefly the emergence of microelectronics, optical fiber; and computer-based alternatives such as the internet, which have revolutionized traditional communications and advertising.[1] These changes can be a significant source of opportunity for growth in postal and delivery services, but taking advantage of these opportunities will require a move to a more commercial, business-like approach to postal service and the incorporation of regulatory innovations such as incentive regulation. H.R. 22 recognizes this mandate and the dangers of not heeding it.

The United States is not alone in moving toward postal reform. Postal administrations worldwide have been moving toward more commercial operations, including adopting organizational and technological innovations developed in the private sector over the past several decades of increasing global competition.[2] The rationale for more commercial operations is simple: increased competition from other communication modes, as well as alternative delivery services, have meant

[1] For a discussion of recent technological and marketing trends in postal and delivery services worldwide, see M. A. Crew and P. R. Kleindorfer, *Managing Change in the Postal and Delivery Industries*, Kluwer Academic Publishers, Boston, 1997.

[2] For a discussion of international trends and issues in postal reform, see M. A. Crew and P. R. Kleindorfer, *Commercialization of Postal and Delivery Services*, Kluwer Academic Publishers, Boston, 1995; and Crew and Kleindorfer, 1997, *op. cit. supra*. Very recently, the Communications Workers Union in the U.K. has put forward its proposals for mail ("Freedom to Deliver—Posting the Way to Greater Success," CWU, London, February 1997) which propose turning the U.K. Post Office into an independent corporation within the public sector, and the creation of an independent regulatory agency administering a scheme of price-cap regulation.

that the traditional civil service bureaucracy coupled with the traditional regulatory process is too slow to respond to emerging market realities. What is required is a market-oriented approach to align the incentives and operations of economic agents involved in postal and delivery services with the needs of their customers. In short, exogenous changes in both markets and technologies of postal and delivery services imply an unavoidable requirement for a significantly greater business orientation in the postal sector.

The changes required to achieve an increased commercial orientation are not just internal to the U.S. Postal Service, but also involve reforms in the regulatory process. It is important to note at the outset that national postal administrations will continue to enjoy residual market power for some time. This means that regulation will continue to have an important role in balancing increased commercial incentives for static and dynamic efficiency, while restraining the exploitation of market power. Postal service is not unique in this regard, and we have seen a similar evolution in other network industries that have undergone the transformation from traditional cost-of-service regulated monopolies to more competitive structures. Indeed, the experience from such industries as telecommunications and energy is of considerable value for the postal sector. This experience has provided the direction for understanding the regulatory innovations likely to achieve the transition to greater competition. The general character of these innovations has been to provide greater autonomy to the incumbent service provider for pricing and product innovation, while encouraging competitive entry into all parts of the value chain except for those displaying the natural monopoly attributes of overwhelming scale or scope economies. In postal service, as in electric power and telecommunications, it is only in the area of "local delivery" that a strong case can be made for the existence of natural monopoly.

The experience in other countries and other industries suggests the key themes that should guide the introduction of reforms in the postal sector. First, the above noted transformations to greater commercialization and streamlined regulatory governance are central. Second, in order for the U.S. Postal Service to align its internal incentives with market requirements, employees of the Postal Service must be given both the rights and the responsibilities of "residual claimants" in USPS, through a stronger link of the economic results of the Postal Service to the salaries and wages of these employees. In particular, the combination of current labor-relations practices and cost-plus regulation have led to a situation in which USPS employees have enjoyed a significant premium over similarly situated employees in the private sector.[3] Under the increasingly competitive conditions which are now unfolding, this cannot continue. Besides the economic inefficiency of such wage differentials, their continuation can lead to significant erosion of mail volumes to competitive alternatives when these differentials are passed on in postal rates. Moreover, a failure to adopt more flexible and market-oriented labor relations practices can lead to delays in adopting new technologies and work practices, with further consequences for the viability and efficiency of the Postal Service. Under the conditions which prevailed prior to the present decade, passing on to labor some of the excess rents of the U. S. Postal Service resulting from its market power might be viewed simplistically as a transfer payment. However, under the current and developing conditions of rapid technological change and proliferating competitive alternatives to postal and delivery services, such excesses will not be sustainable which will force the postal sector to become efficient or face the threat of extinction in several of its lines of service through the forces of competition.

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[3] Perloff and Wachter have estimated the magnitude of the postal employee premium at 28%. See Jeffrey M. Perloff and Michael L. Wachter, "A Comparative Analysis of Wage Premiums and Industrial Relations in the British Post Office and the United States Postal Service", in M. A. Crew and P. R. Kleindorfer (eds), *Competition and Innovation in Postal Services*, Kluwer Academic Press, Boston, 1991.

2. H.R. 22

Against the above perspective, H.R. 22 is a critical legislative initiative. It recognizes that now is the time for major reform. It proposes the adoption of state-of-the-art regulation in the form of price-cap regulation.[4] However, in our view, H.R. 22 itself is in need of reform if it is to provide the foundation for a solid future for the U. S. Postal Service and other participants in the U.S. postal and delivery services market. We will suggest a few key areas in H.R. 22 that we believe could benefit from change.

Let us first note our strong support for the vision in H.R. 22 of reforming the current system, while retaining the fundamental features of postal service. These include primarily the "universal service obligation," (USO) which implies the ubiquitous availability of postal service at a uniform price and with protection from market power exploitation via regulation. We also support the H.R. 22 proposal to move away from cost-of-service regulation, as currently practiced in postal ratemaking, to incentive regulation, which has been effective in other industries in improving efficiency while reducing regulatory transactions costs.[5] Our chief concerns regarding the current version of H.R. 22 relate to the following:

- The lack of appropriate residual claimants to ensure that price caps will result in efficiency gains.
- The incompatibility between current labor relations practices for postal employees and the supposed dictates of price caps for continuing real price reductions.
- H.R. 22's treatment of product baskets, service quality monitoring, and the implementation of price caps for these baskets.

Absence of Residual Claimants: Incentive or, specifically, price-cap regulation has been applied almost exclusively to privately-owned companies, rather than public enterprises. Notably in the United Kingdom, price-cap regulation was the regulatory scheme adopted for the newly privatized enterprises not only among network industries, viz. gas, electricity, telephone and water, but also for other industries such as the British Airports Authority. The U.K. Post Office was not privatized and not subject to price-cap regulation. Similarly, in the U.S., price-caps have applied primarily to telecommunications companies. The fact that these companies are privately-owned largely explains the potential of price caps in achieving more efficient operation than cost-of-service regulation. Under price caps, shareholders and top management, as residual claimants, have the opportunity to enjoy the extra profits that result from increasing the efficiency of operations. However, if the Postal Service were simply subject to price cap regulation with no change in ownership or residual claimants, there is absolutely no guarantee that efficiency will be improved, as there would otherwise be no, or at best weak, residual claimants to benefit from increased profits. Indeed, additional profits might be arguably counterproductive, in that they might send a signal to postal employees that the Postal Service could pay more. Unlike a private company, the Postal Service,

[4] Price-cap regulation allows prices to change each year by a price index, which measures the overall level of inflation, e.g., the CPI, but requires a real reduction in prices each year of X percent. That is, prices may rise by CPI - X, where the X factor is the real reduction in prices. Under price caps, customers are guaranteed a real price reduction. Indeed. they could conceivably receive a nominal price reduction, if the X factor were greater than the CPI.

[5] For a discussion of recent findings on the effectiveness of incentive regulation, see M. A. Crew and P. R. Kleindorfer, "Incentive Regulation in the United Kingdom and the United States: Some Lessons," *Journal of Regulatory Economics*, 9 (3): 211-226 (May 1996).

absent any other strong residual claimants,[6] would have little incentive to stand firm, as management would have little to gain from doing so. In addition, a public enterprise is not subject to the pressure of competition in the same way that a private company is, in that it is insulated from bankruptcy. This insulation from the discipline of bankruptcy also means that a public enterprise, unless strongly reined in by the government, can get into competitive ventures on favorable terms and therefore compete unfairly and inefficiently with privately-owned companies.

Absent privatization, there is no strong residual claimant to assure a proper allocation of scarce resources.. Some efforts can be made to establish residual claimants by allowing for strong management incentives and profit targets as, for example, has been the case in Australia and New Zealand, where the post offices are still public enterprises. However, the government's powers to punish failure are weak compared to the market. Thus, in Germany and the Netherlands, the incentives for efficiency may be stronger, as in both cases either a schedule for privatization is in place or some portion of the stock is already privately owned. The implications for the U.S. Postal Service are clear. Absent privatization or a schedule to privatize, the benefits to be expected from incentive regulation are likely to be reduced significantly.

Need to Reform Labor Relations Practices: In view of the current labor relations framework within which the U.S. Postal Service operates, absent privatization, the improvements in efficiency are likely to be small or non-existent. The current system involves binding arbitration. Thus, approximately 80% of the Postal Service's costs are subject to the decision of an arbitrator. The arbitrator is not obliged to abide by the price cap. He may award significantly in excess of the rate of increase allowed by the price cap. If this happens, the Postal Service would have no alternative but to seek rate relief on the grounds of impending financial exigency! With this system of labor relations, there is thus little likelihood that the benefits of cost economy promised by price caps will be achieved in the Postal Service.

Implementation Issues in H.R. 22: H.R. 22 has a number of problems in the structure of the price cap which it proposes. One concern is with its uniform applicability of adjustment factors in a basket.[7] No individual price within the basket is allowed to increase by more than the price index, which is specified in H.R. 22 as the GDPPI less X. This contrasts with the more common arrangement where the prices in the basket are aggregated into an index which is allowed to increase by the GDPPI - X. This indexing approach is much more flexible, in that it allows some prices to rise by more than the index and some actually to decrease. Under H.R. 22, since price reductions would not count, there would be very little incentive not to increase a price by less than the maximum allowed. Thus, the potential for adjustments within the basket would be minimal and would tend to perpetuate existing inefficiencies and fail to provide the flexibility and opportunities for change usually allowed in price-cap regulation.

Another concern is the actual structure of the baskets. H.R. 22 provides for four baskets, which comprise the vast majority of the revenue of the Postal Service, including some products that should be considered competitive. Too many mail products are considered monopoly type products when they are subject increasingly to competition. For example, bulk mail, periodicals, parcels and presort mail are all considered monopoly type products, yet they all face actual or potential competition. The inflexible price cap regime that is employed is unsuitable for such products, some of which would properly be considered competitive and not therefore subject to a price cap. The effect of this is to fail to provide the flexibility that the Postal Service needs to compete.

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[6] It is difficult to argue in a credible manner that taxpayers are meaningful residual claimants..

[7] Each basket is subject to a separate adjustment factor. While we argue that this serves no useful purpose, we are concentrating here on the more serious problem of failing to allow intra-basket pricing flexibility.

3. Some Alternative Directions

If incentive regulation in the form of a price cap is to replace the current system, other changes will be required in addition to those envisaged in H.R. 22. They fall into two main categories. First, the desired incentives for efficiency implicit in the introduction of price-cap regulation will not be achieved if the current system of residual claimants continues. Second, the recognition of competitive realities and the importance of flexibility in a changing market place is inadequate to allow postal and delivery markets to develop in the future.

The current system of residual claimants could be changed in a number of ways. We propose considering two possibilities. The preferred approach would be to privatize the Postal Service and to end the system of binding arbitration. A second-best approach would be to end binding arbitration but to continue the Postal Service as a public enterprise with increased incentives for commercialization, including stronger bonus systems and other incentives for management, together with employee stock-ownership or other means (e.g., productivity or gain-sharing plans) for directly connecting employee remuneration to enterprise performance.[8] Under the second-best alternative, given that the Postal Service would still be a public enterprise, neither employee stock ownership nor other internal incentive systems are likely to impose sufficient discipline to control labor costs or to promote moves to labor-saving technological progress. The result might be little or no better than the status quo.

H.R.22's approach to competition, the structure of the baskets, and the nature of the price cap do not adequately address the realities of competition and the importance of change in the emerging market in postal and delivery services. We offer an alternative approach that provides the flexibility to address the emerging competition and the rapidly changing market place for communications. Our approach, which derives from our earlier work,[9] concentrates on those parts of the market where the Postal Service has monopoly power and focuses the regulation there. Thus, we propose that price regulation should apply only to monopoly services and not to a wide class of products. Services provided by the Postal Service would be divided into two baskets. One basket would consist of all regulated (or reserved) services, and the other basket would be the unregulated services. The regulated basket would consist of only those services where there was monopoly power, and PCR would apply only to this regulated basket. All other services would be in the unregulated basket.

How would services be identified for each basket and what would be the nature of the monopoly? In view of its universal service obligations, the Postal Service should continue to have some monopoly protection. Usually an upper limit is provided on the scope of the monopoly (e.g., in terms of a multiple of the single-piece First-Class postage rate).[10] The items in the regulated basket would be all services below the monopoly limit. Thus, the monopoly limit would cover all First-

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[8] A small part of the stock would initially be subject to employee ownership. While questions would arise as to the stock's market value since it would presumably not be quoted on the stock exchange, the problem is presumably not insuperable given that the largest delivery company in the world, United Parcel Service, is employee-owned.

[9] See M.A. Crew and P.R. Kleindorfer, "Pricing, Entry, Service Quality and Innovation under a Commercialized Postal Service," in J. Gregory Sidak (Ed), *Governing the Postal Service*, The AEI Press, Washington, D.C., 1994. Our approach was in part inspired by the work of Stephen Littlechild, the Director-General of the Office of Electricity Regulation, (OFER) in the U.K. See especially, S. C. Littlechild, *Regulation of British Telecommunications' Profitability*, London: Department of Trade and Industry, 1983.

[10] The amount of the limit should ideally be set as a function of the universal service obligation (USO). The details are beyond the scope of this testimony. See the extended discussion of the USO in Crew and Kleindorfer, *op. cit. supra*, 1997.

Class mail, as presently, plus the rate for access to the local delivery network. The price-cap index that we would envisage would be rather simple. The regulator would cap prices for basic (single-piece) First-Class postage and for access to the local delivery network for the first ounce and each subsequent ounce. In addition, the price of special services and services mandated by Congress, such as material for the blind, certified mail, and registered mail would fall within the price cap. The Postal Service would be free to raise rates at the rate of standard index-minus-X formula over the period of the price-cap. With only two principal products in the regulated basket, the Postal Service would have to decide how much to increase the price for each product so as to keep the index of the two products within the rate of increase allowed. The Postal Service would be allowed to set all other prices—the unregulated basket--without regulation. Thus, Second-, Third-, and Fourth-[11] Class mail would not be subject to regulation. The Postal Service when subject to price-cap regulation would not have the incentive to cross subsidize its unregulated services as it might under cost-of-service regulation.[12]

Although the Postal Service would have considerable latitude in pricing its barcode and other bulk mail operations, it would still be subject to certain constraints. In particular, its access price would represent a floor below which it would not be able to set its prices for its other services. For example, a rate for bulk barcoded mail could not be set below the rate for access. Similarly, the ceiling price that it would be allowed to charge would be the price-cap on single-piece First Class. Between the floor and the ceiling, the Postal Service would be free to set prices for its unregulated products (including all so-termed work-sharing products). In addition, a privatized Postal Service would of course be subject to the full force of the antitrust laws just like any other private company.

While our proposals represent a significant departure from the current practice of postal regulation, they are consistent with current practice in other industries, as well as with Littlechild's (1983) price cap proposal. As such, they carry all the well-known advantages and disadvantages of PCR. The advantages include the incentives provided for cost economy and efficiency, the reduced transactions costs in avoiding rate hearings, and the pricing flexibility provided in the competitive markets. In addition, the plan provides some protection against monopoly exploitation and a regulatory governance structure for resolving disputes. The disadvantages include problems in determining the initial level of the price cap and maintaining quality of service. Under PCR, the regulated firm has an incentive to reduce quality of service, since it can reduce costs and therefore increase profits as a result of reducing the quality of service.

Setting the initial level of the price cap has been problematical in telecommunications because of the existence of significant cross-subsidies. However, with postal service, the main cross-subsidies are not between products but within product classes. Thus, the main cross-subsidy of First-Class mail customers in outlying areas is provided by other First-Class mail customers. Setting the monopoly limit at, say ten times the First-Class initial ounce rate, is intended to address this problem. The conclusion that we draw is that the initial level of the price cap is not expected to be very different from the structure of current rates. Some one-time individual adjustments may have to be incorporated into the initial price cap to take into account, for example, the problems of under-funding of pension benefits and the setting of a target rate-of-return on capital.

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[11] Third- and Fourth-Class mail are now known as "Standard Mail" following reclassification. See *Opinion and Recommended Decision*, Docket No. MC95-1, Postal Rate Commission, Washington, DC.

[12] Under properly designed price caps, the incentives to avoid cross subsidization of competitive products have been examined in Ron Braeutigam and John Panzar, "Diversification Incentives Under 'Price Based' and 'Cost Based' Regulation," *Rand Journal of Economics*, Autumn 1989, 20 (3): 373-91.

Under PCR an important change takes place in the regulator's duties. The Postal Rate Commission would have to be more concerned about quality of service to assure that service quality erosion does not take place in either of its two monopoly baskets of services (end-to-end First-Class and Access). Currently, the U.S. Postal Service and the U.K. Post Office employ independent consultants to monitor service quality. Such efforts would continue perhaps at an increased level with reports being made by the consultant to the regulator as well as the Postal Service. Continuation of such efforts would be relatively straightforward and important.

A related area would be product mix. To be able to compete in rapidly changing communications, postal, and delivery markets, the Postal Service should be encouraged to be innovative. Product introductions should therefore be new services which would remain unregulated for at least three years or until the end of the period of the price cap, whichever were longer. This arrangement would provide the opportunity for the development of many new services, not just variations on its unregulated services. (If a new service were to replace an existing regulated service, permission of the regulator would have to be sought.) The intent is to encourage product innovation. Thus, the Postal Service would not be subject to rigid line-of-business restrictions as embodied in existing reclassification procedures, which are unaffected by H.R. 22.

It is important for the Postal Service to be innovative in the current situation of competition and technological change, and these kinds of procedures would give the Postal Service an incentive to promote cost economy and to develop new services. By being guaranteed at least three years without regulation for new products that did not replace existing regulated products and being, therefore, allowed to keep all the benefits of the new product for this period, the Postal Service would be encouraged to develop new products. Postal customers would, however, still be protected from abuse of monopoly power by these procedures through the two-basket approach outlined above for existing services.

4. Conclusions

Absent major changes, the Postal Service will not be able to survive in its present form. There will be major reductions in employment levels and large reductions in mail volume. With around three-quarters of a million employees, such considerations can hardly be brushed aside. The wrong decisions now could be serious if they send almost three-quarters of a million people in the wrong direction. H.R.22 is important in recognizing the need for change and proposing incentive regulation, but it does not address the problem adequately. It does not recognize the urgency of the situation. Just because the Postal Service is currently doing quite well does not mean that significant action can wait. Now is the time, while things are still going well, to make changes. The objective of regulatory reform is to unleash entrepreneurial spirit now in the postal sector, both in the U.S. Postal Service, as the backbone provider, as well as in the growing number of competitors in the postal and delivery industries. What is needed is a new governance and regulatory structure for the Postal Service which will allow internal and external entrepreneurs to innovate and align postal services with the changing nature of technology and communications requirements in the age of the internet.

We propose a privatized Postal Service operating under private sector labor relations practices, together with price-cap regulation. The price cap would be confined only to monopoly services, namely, single-piece First Class and a new product, "access" to the local delivery network. Other products would be considered competitive and not subject to regulation. With this system in place, the Postal Service would be able to compete and find its appropriate place in the market for postal and delivery services in an age of rapidly expanding electronic communications.

APPENDIX 2: FINANCIAL DISCLOSURES

In the fiscal year ended September 30, 1996, Drs. Crew and Kleindorfer received $15,284.34 and $7,585.00 respectively in the form of consulting income from the United States Postal Service.

In the fiscal year ended September 30, 1996, the Center for Research in Regulated Industries received sponsorship for its conference "Managing Change in the Postal and Delivery Industries" for the following amounts

U.S. Postal Service	$10,000.00
U.S. Postal Rate Commission	$5,000.00
Federal Express	$5,000.00
United Parcel Service	$5,000.00
Price Waterhouse	$3,500.00

A complete list of sponsors can be found in Appendix 3 which provides a copy of the program for this year's international conference, *The Evolving Structure of Postal and Delivery Industries.*

APPENDIX 3: CONFERENCE PROGRAM 1997

Fifth Conference on Postal and Delivery Economics:

THE EVOLVING STRUCTURE OF POSTAL AND DELIVERY INDUSTRIES

June 11-14, 1997
Helsingør, Denmark

THE STATE UNIVERSITY OF NEW JERSEY
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CENTER FOR RESEARCH IN REGULATED INDUSTRIES
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THE EVOLVING STRUCTURE OF POSTAL AND DELIVERY INDUSTRIES

Wednesday, June 11, 1997

5:00 - 6:00 pm Registration

6:00 Reception—*Hosted by Price Waterhouse World Postal Industry Group*

7:00 *Welcome and Introduction to Conference*
Michael A. Crew and Paul R. Kleindorfer
Dinner & Speech: **Palle Juliussen**, Chief Personnel and Planning Executive, Post Danmark

9:00 After Dinner Drinks

Thursday, June 12, 1997

7:30 a.m. Breakfast

9:00 - 10:30 **LEGAL ISSUES**
Chair: Oluf Raldorf
Discussants: Mario Dunn, Per Forsberg, and Pekka Leskinen
Stephen Agar and Ian Reay: Postal Regulation and EU Competition Law
Catherine Churchard, and Françoise Blum: The Postal Network: Essential Facility or Commercial Asset?
William E. Kovacic: Postal Services Regulatory Reform in Transitional Economies

10:30 - 10:50 Coffee Break

10:50 - 12:20 **REFORM I**
Chair: Michael A. Crew
Discussants: Jean-Paul Forceville and John C. Panzar
Robert G. Taub: Postal Reform in the United States: A New Paradigm
James I. Campbell: U.S. Postal Reform: a Competitor's View
Nigel Attenborough and Jonathan Sandbach: Employment Effects of Liberalizing Direct and Cross-Border Mail
Axel Kirmess: Postal Reform in Germany

12:20 - 1:45 Lunch

1:45 - 3:15 **REFORM II**
Chair: Nancy Staisey
Mary E. Bundy: An Examination of the Canada Post Mandate Review
David Treworgy, Thomas Sharkey, David Fronk & Michael Kehoe: Regulation and Reform of Postal Administration: An Informational Comparison and Assessment
Commentary: John Allen

3:15 Break

6:00 Reception

7:00 *Dinner & Speech:* **Ian Bourne**, Senior Vice President and CFO, Canada Post

9:00 After Dinner Drinks

Friday, June 13, 1997

7:30 a.m. Breakfast

9:00 - 10:30 ***Concurrent Sessions***

DEMAND ANALYSIS
Chair: Börje Spong
Discussants: Hansje Huson and Heikki Nikali
John Nankervis and Frank Rodriguez: How Important Have Price and Quality of Service Been to Mail Volume Growth?
Ikuo Izutsu and Ichisa Yanaura: The Summary of the Study on Replacement of Letter Mail Services by Telecommunications Services in Japan

REGULATION
Chair: Edward J. Gleiman
Discussants: Nancy Sparks, David Storer, and Tim Walsh
Bernard Roy and Joelle Toledano: Terminal Dues and Market Structure: the Contribution of Economic Analysis
Monika Plum: Is there a need for sector-specific regulation in liberalized postal markets?

10:30 - 10:50 Coffee Break

10:50 - 12:20 ***Concurrent Sessions***

COST ANALYSIS
Chair: Peter Johnson
Discussants: Donald O'Hara, Roger Sherman, and Anton van der Lande
Michael D. Bradley and Jeffrey Colvin: More than Kin or Less than Kind? Aggregating the Components of Postal Costs
Rodney Maddock: Some Evidence on the Economics of Local Delivery for Mail
Jean-Pierre Florens, Cathy Cazals, and Marc DeRycke: Regrouping of Post Offices: Econometric Valuation and Efficiency Measurement

STRATEGIC ISSUES
Chair: Jens Nielsen
Discussants: Thomas Baldry, Leon Pintsov, and Alan Robinson
Tapio Liikanen: Scenarios as a Means of Strategic Management of Finland Post
Herbert Gilbert and Mary K. Perkins: Should Postal Operators Play in the Cyber-Mart?

12:20 - 1:45	Lunch
1:45 - 3:15	**ENTRY-ACCESS** Chair: John Dolling Discussants: John Haldi **Robert Cohen, Ed Chu, William Ferguson, John Waller, and Spyros Xenakis:** Cream Skimming Potential in the United States Postal System **Marshall Kolin and Edward S. Smith:** Profitability of Mail Delivered on Rural Routes
3:15	Break
6:30	Reception
7:30	*Dinner & Speech:* **William Henderson,** Chief Operating Officer, United States Postal Service
9:30	After Dinner Drinks

Saturday, June 14, 1997

7:30 a.m.	Breakfast
9:00 - 10:30	**UNIVERSAL SERVICE I** Chair: John Reynolds Discussants: Sture Wallander **Michael A. Crew and Paul R. Kleindorfer:** Efficient Entry, Monopoly and the Universal Service Obligation in Postal Service **Jens Nielsen, Rainer Nitsche, and Christian Kofoed-Enevoldsen:** Universal Service Obligation in the European Postal Sector-The Case of Denmark **David A. Rawnsley and Nomi Lazar:** Managing the Universal Service Obligation
10:30 - 10:50	Coffee Break
10:50 - 11:50	**UNIVERSAL SERVICE II** Chair: Bill R. Price Discussants: Eric Merkel-Sobotta and John C. Panzar **Virpi Palo:** A Comparative Study on Services of General Interest in the EU: Universal Postal Services and the Network **Ulrich Stumpf:** The EU Framework for Ensuring Universal in Telecommunications: Lessons for the Postal Sector
11:50 - 12:30	**CONCLUDING PANEL DISCUSSION—Regulation of Postal Service and Competition** Chair: Michael A. Crew Panelists: James I. Campbell, John C. Panzar, Roger Sherman, and Joelle Toledano
12:30 - 12:35	Concluding Remarks —Michael A. Crew
12:35 - 2:00	Lunch (Conference Ends)
2:00	Conference Ends

ORGANIZING COMMITTEE

John Allen (New Zealand Post)
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James Campbell (IECC)
Robert Cohen (U.S. Postal Rate Comm.)
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FEES AND EXPENSES

- A registration fee of **$810** is payable to the Center for Research in Regulated Industries.
- The charge for food and lodging for the duration of the Conference is approximately 3,095 DKK.
- The conference fee is waived for a limited number of employees of sponsoring organizations.

CONFERENCE STAFF

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C.R.R.I.

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Helsingør, Denmark
June 11-14, 1997

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SPEAKERS AND DISCUSSANTS

STEPHEN AGAR, Asst. Director—Postal Services & Regulation, UK Post Office Legal Services
JOHN ALLEN, General Manager—Planning and Communications, New Zealand Post
NIGEL ATTENBOROUGH, Associate Director, NERA
THOMAS BALDRY, Manager—Marketing Services Infopost, Deutsche Post-AG
FRANÇOISE BLUM, Senior Competition Law, Clifford Chance
MICHAEL D. BRADLEY, Professor, George Washington University
MARY E. BUNDY, Director, LINX
JAMES I. CAMPBELL, Counsel, Federal Express Corp.
CATHY CAZALS, Researcher, IDEI
CATHERINE CHURCHARD, Legal Services Director, U.K. Post Office
ROBERT COHEN, Director, Technical Analysis & Planning, U.S. Postal Rate Commission
JEFFREY COLVIN, Principal Economist, U.S. Postal Service
MICHAEL A. CREW, Professor, Rutgers University
MARC DE RYCKE, La Poste
JOHN DOLLING, Head of Strategy Development, Royal Mail
MARIO DUNN, Head of Policy, Communications Works Union
JEAN-PIERRE FLORENS, Professor, IDEI
JEAN-PAUL FORCEVILLE, Head—Strategic Planification Department, La Poste
PER FORSBERG, Sweden Post
DAVID FRONK, Economist, U.S. Postal Service
HERBERT GILBERT, Economist, U.S. Postal Service
EDWARD J. GLEIMAN, Chairman, U.S. Postal Rate Commission
JOHN HALDI, President, Haldi Associates, Inc.
HANSJE HUSON, Consultant—Postal Affairs, PTT Post, Netherlands
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AXEL KIRMESS, Bundesministerium für Posts und Telekommunikation
PAUL R. KLEINDORFER, Professor, University of Pennsylvania
CHRISTIAN KOFOED-ENEVOLDSEN, Head of Organization and Planning, Post Denmark
MARSHALL KOLIN, Economist, U.S. Postal Service
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TAPIO LIIKANEN, Business Planning Manager, Finland Post
RODNEY MADDOCK, Professor, La Trobe University
ERIC MERKEL-SOBOTTA, Director—European Affairs, United Parcel Service
JOHN NANKERVIS, Reader, University of Surrey
JENS NIELSEN, Manager-Centre of Excellence for Postal Consulting, Price Waterhouse
HEIKKI NIKALI, Researcher, Finland Post
RAINER NITSCHE, Manager, Price Waterhouse
DONALD O'HARA, Principal Economist, U.S. Postal Service
VIRPI PALO, Project Manager-Quality and Business Development, Finland Post Ltd.
JOHN C. PANZAR, Louis W. Menk Professor of Economics, Northwestern University
MARY K. PERKINS, Associate Professor, Howard University
LEON PINTSOV, Fellow—Advanced Concepts and Technology, Pitney Bowes, Inc.
MONIKA PLUM, Senior Economist, WIK
BILL R. PRICE, Director—Rate Economics & Product Costs, Canada Post
OLUF RALDORF, Deputy Director—Sales & Marketing, Post Danmark
DAVID A. RAWNSLEY, Senior Vice President, LINX
IAN REAY, Head of Operations Research, U.K. Post Office
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ULRICH STUMPF, Deputy Director, WIK
ROBERT G. TAUB, Pr.Stf.Mem./Chief Investigator, House Subcommittee on the Postal Service
JOELLE TOLEDANO, Head of Economics and Mailing Prospectives Department, La Poste
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ANTON VAN DER LANDE, Vice President—Public Affairs International, United Parcel Service
STURE WALLANDER, Sweden Post
TIM WALSH, Director—International Affairs and Business Strategy, Royal Mail International
IEHISA YANAURA, Senior Research Officer, IPTP—Ministry of Posts and Telecommunications

Mr. MCHUGH. Thank you, Professor.

Are you sure you don't want to take a few minutes and talk about the good things? We appreciate your comments.

I would like to start out on a kind of general basis, and before I do that, let me first of all recognize the presence of the gentleman from Illinois, Mr. Danny Davis, who has joined us. He has been a real stalwart since appointment to this subcommittee, and we appreciate his presence.

The gentleman from Ohio, Mr. Steve LaTourette, had to leave to preside over the session which began a few moments ago. We appreciate his being here as well.

Professor Kleindorfer made some comments about what the future looks like. I can tell you that we didn't get involved in this procession just for the exercise. We felt that there was a need to prepare for the future, and we felt as well, at least strategically, it is better to act absent an immediate crisis atmosphere, where you can think about things in a more reasoned and reasonable manner.

Listening to Dr. Popkin, I am not certain he would agree with the need to make what he might consider overly dramatic changes. I am always reminded of the old saying: Before the Little Big Horn, George Custer was undefeated. I think we do have to worry about tomorrow.

But if there is no need, if the Postal Service of tomorrow is going to be fine, then there is no need to do this at all. So I would like—and Professor Kleindorfer mentioned some of the things that he felt would happen—I would like to have each of you just respond to what you think the future of the Postal Service will be under status quo, be it good, bad or indifferent.

I know that a number of you have not been involved in postal issues, but you did take a lot of time—and I appreciate that—in looking at the Postal Service vis-a-vis the rate structure we are talking about. If you formed an opinion, I think it would be interesting. Maybe we ought to turn out the lights and go home.

Mr. KWOKA. I am not an expert on the Postal Service, but I have spent a bit of time looking at the issues here, and I would offer the following opinion based both on what I am familiar with in the Postal Service and other industries.

Advocacy of price gap regulation stems from the belief that the cost of service regulation in any context where we have seen it does not work well, does not encourage efficiencies, and, almost without exception, except for badly flawed plans, will produce a superior degree of efficiency and benefits to both consumers and the companies.

So I would offer the view, based on a wide range of other companies and industries both in this country and others, that taking exactly the same enterprise, subjecting it to the incentives of rate of return regulation, and then, in the alternative to the incentives under price caps, there should be little doubt which of those will produce a superior set of performance records in the future.

I have no crystal ball, particularly with regard to how the Postal Service might perform in the absence of some cut over to price gaps, but the straightforward comparison that I think is embodied in H.R. 22 and is before this subcommittee is one that I think of-

fers a great deal of credence to the view that price gaps, at a minimum, ought to be able to improve on whatever it is in the alternative that might happen to the service.

Mr. MCHUGH. Thank you.

Dr. Rose, you noted particularly that you had not worked on postal issues before but you enjoyed this.

Mr. ROSE. Right.

Mr. MCHUGH. I want to hear you say that when you walk out of the room, but we believe you for now.

Mr. ROSE. It is actually getting better. It is more interesting. Well, most of my remarks and what I wrote was focused on price caps and what you are proposing in H.R. 22.

There is an aspect in H.R. 22, that I warmed up to that I recognized in the utility debate, and that is Aunt Minnie. I think Aunt Minnie is in there. And that is the idea of preserving some basic service in the form that most people have become accustomed to. My general impression is, the Postal Service does a very good job on that.

In the utility field, even in the talk of restructuring, there is always, we are going to have to take care of—there is no Aunt Minnie, we usually talk about little old ladies freezing in the dark as the problem, and where little old ladies in sneakers is what they say in telecom, it is the same equivalent argument. You have to have some kind of basic service, some kind of fallback.

That is what I perceived, and I could be wrong on this, but that is what I perceived was going on in H.R. 22, to set those aside. Clearly, if in the extreme, if there was competition for First-Class letters and First-Class cards, I don't think Aunt Minnie would be able to mail a Christmas card to her nieces and nephews across the country for 32 cents. That is a heck of a bargain, and we have to recognize that. I think I recognize the need to want to preserve that, and I recognize that same thing in the utilities.

So that is what I think is going on, not so much as trying to open up everything to competition, even though, as an economist, I am genetically predisposed to think competition is better for everything, but I recognize the limitations.

Mr. MCHUGH. Thank you, sir.

Before we proceed to Dr. Popkin, I want to recognize Pete Sessions, Congressman Sessions, the gentleman from Texas.

Thank you for joining us, sir.

Mr. SESSIONS. Thank you. I appreciate that.

Mr. MCHUGH. Before we ask for your comments, Dr. Popkin, let me just say, I couldn't agree with you more with respect to the very, very admirable job that the Postal Service, and particularly the postal workers, have done.

I have said many times to similar meetings such as this and in various forums, I live in a very small community that relies very heavily on a universal delivery standard that is delivered and brought to us by those postal workers, and they have my utmost admiration.

What I am concerned about is what happens tomorrow or the day after tomorrow without these kinds of changes. You feel, I suspect, that this procedure is not necessary. But I don't want to put

words in your mouth. What do you think the Postal Service of tomorrow would look like under status quo?

Mr. POPKIN. I think that in the context of the way you have framed this: What is the future for the Postal Service? as I hear Mr. Kleindorfer describe it, I think the only way the Postal Service could resolve the future he has in store is to become a Microsoft or an IBM.

The problem is electronic communication. There is no wage and price at which the Postal Service can compete with electronic communication. That is going to happen. That is technological progress. We can't turn that back.

Rather, the way I view it is that there is a delicate balance that you have in this institution, that the institution called the Postal Service creates. In jargon my colleagues on the panel would recognize, the various forms of alternative communication, such as electronic communication, create what are called contestable markets.

The Postal Service really isn't a monopoly. Some of its markets are contested. By the same token, it does a very helpful thing for the U.S. economy. It resolves a very difficult cross-subsidization issue that Mr. Rose was talking about. In other words, how do you get mail to Aunt Minnie at 32 cents out in farmland in the United States?

When I look at the problems that we are having in resolving cross-subsidization issues, I think there is an ongoing debate—you read about it almost every day in the paper—between the long-distance and local telephone companies, about this access charge, which really is a cross-subsidization. These are very difficult matters to handle.

Mr. Sidak mentioned maybe there are some alternative ways to deal with cross-subsidization. I think that is what they are struggling with in terms of Internet access, some kind of pools where companies put some money into something and that can be used to hook lines up to all the schools in the hinterland.

But I think that the biggest competitive threat is a technological one that you can't do anything about, and meanwhile the Postal Service faces contestable markets and yet it makes this very delicate transfer by providing universal service at uniform rates.

So I am upbeat. I am a fan of the Postal Service.

Mr. MCHUGH. I am as well. Believe me, one of the primary objectives I have personally is to keep that universal service into what you call the farmland. I would like to keep it into the inner-cities as well. I think all of that is important. But I appreciate your comments.

Mr. Sidak.

Mr. SIDAK. Thank you.

Universal service is an issue that comes up in every one of the regulated industries. It is useful to look at what Congress did last year in the Telecommunications Act. It said universal service is important, we are going to preserve it. We are even going to expand the definition to take into account new technologies. But we are not going to tolerate monopolies. State-sanctioned local exchange monopolies are preempted.

Of course, there wasn't anywhere on the table a proposal to resort to public ownership of telecommunications networks in the name of providing universal service.

Now, what has happened since the act passed? A Federal-State joint board has met, and it, in accordance with the instructions that Congress gave, has attempted to identify ways of making subsidies transparent and explicit, rather than hidden in the rate structure, and to make them competitively neutral so that they don't favor any one competitor in the market.

That is a process that follows efforts by many of the State commissions for several years now to address universal service in telecom and in other industries. In New York, for example, there is a case that has been going on since 1994, to address the funding of universal service in a competitively neutral way in local telephony.

I think part of what we are seeing is that the Postal Service is a giant army that has been assembled to win the war of delivering universal service. We have won that war and now have a large standing army. We have to figure out what to do with that army now that the mission is accomplished. Particularly if electronic means of communication make letter mail less important to consumers in the future, there will be a large labor force that is not as necessary to a public mission as it once was.

That, in turn, I think, raises a question of what is the future objective of the Postal Service and its management. I am concerned that the Postal Service not stray farther and farther away from the original mission of this public enterprise, which was to provide universal service and bind the country together. I think that the Postal Service has accomplished that goal admirably.

Mr. MCHUGH. Gentlemen, I will defer to you. Who prefers to go first?

Mr. KLEINDORFER. I would like to comment briefly directly to the question you raised, Mr. Chairman, about whether the future is rosy or not.

Our view is that one doesn't have to know exactly what the future is in order to know that flexibility and the opportunity to fit well are important attributes.

I personally view, having reviewed over the past 7 or 8 years the issues of the technological threat and erosion of mail volumes, especially in the advertising area—I have some views about what is happening there. I think my views are perhaps best put in terms of saying that there is a real threat from electronic competition.

The vast majority of mail, First-Class and bulk mail, either originates or destinates with business. Those businesses are looking for opportunities to more effectively communicate. They are going to find them. With the growth from a mere 1 million Internet users in 1996 to 100 million projected by the turn of the millennium, we can expect them to find success in this respect.

So business as usual? I would expect a bureaucratic enterprise, certainly one that is very devoted, and I would take nothing away from the intent of the people that work there.

But the opportunity to compete and evolve will not be there. They will be forced to go through lengthy procedures, just as they do now, to reclassify, to introduce new products. There will be sig-

nificant line of business restrictions, inflexibility will naturally obtain, and I do not see that as providing the necessary confluence with an adaptive communications marketplace.

If they change, then I see actually a fairly—I believe what we have heard and what we know about the competence of the postal employees here and the management, I think we can anticipate those folks can compete just like Microsoft or IBM, but they have to have the framework within which they can do it.

To try to reinvent all of corporate law, everything else that actually surrounds the private firm through a piece of legislation, that is not going to work. We have got huge legal precedents and procedures that define exactly what it is to be a corporate entity.

It seems to me that that is our hope for not just a so-so future for the Postal Service but for a future that, in fact, emulates that which our private sector has gone through in the last 10 years through its own restructuring activities, giving us a tremendous boon in employment, a tremendous boon in satisfaction for those who even have been outsourced and started new businesses. Those are the kinds of activities that arise naturally from trusting in the market.

If we trust in bureaucracy, I am afraid we will get further and further entangled into it, just as my colleague, Dr. Sidak, has explained as the other alternative. So business as usual, means bureaucracy, change with I think we have got some hope of evolving, of seeing an adaptive Postal Service as a part of the next millennium.

Mr. MCHUGH. Thank you.

Dr. Crew, would you like to add something?

Mr. CREW. I would add little to that, except to say we have been thinking about this and working on this problem for a few years, and in fact this particular issue that we proposed in our testimony for reorganization of the Postal Service was first unveiled 2 or 3 years ago at a conference at the American Enterprise Institute organized by Mr. Sidak. At that particular conference, we actually came short of recommending privatization.

But I think my colleague put it very well when he said that we don't want to reinvent the whole of corporate law and things like that to make this work. We have got an institution, the private corporation, which could do the job, and that would be the way to go in the present situation.

In terms of why do we see the picture as somewhat bleak, in the international conferences that we have been participating in, most of the Europeans are much more concerned about market erosion than people seem to be here. The papers have been written, econometric papers on this, that show significant competitive effects from electronic media, and much, much more important, growing potential.

Mr. MCHUGH. I am probably getting close to the 5-minute limit. I would like to yield to the ranking member and thank him for his patience.

Mr. FATTAH. Any time the chairman is talking, I don't even look at the clock. I do understand the role of the minority here in the Congress.

Let me say that the future is now in many respects, because I am going to have to depart from this hearing very soon, but I do want to make a number of comments. One is that I do appreciate all of your testimony today and the various levels of inspection you bring to this matter.

I am concerned that perhaps some of us are working at cross purposes inasmuch as I am not sure that we are talking about the same thing. I want to work with the chairman, and I know that he is interested in reforming the Postal Service.

But I am interested in reforming it as a public good and a public enterprise dedicated to public service, which I think is the basic mandate under which it is operating now. And the notion of privatization, and even some of what has been talked about in terms of commercializing the Postal Service, concerns me, because I think that, as economists, obviously you are looking at a different set of dynamics than perhaps those of us as public officials may be looking at.

I am much more interested in Aunt Minnie, I think was the term of art Mr. Rose used, and whether she can have a reliable vehicle. She may not be surfing the net, not today, not tomorrow, and not any time in the near-term future.

And I note that there is a lot of interest in thinking about what the future may bring, and the Government itself is taking certain steps. We are moving all of our payments to electronic form. That is going to cost the Postal Service $100 million. This is a real issue.

But I am not sure price caps, in and of themselves, address any of the issues relative to the competition brought on through electronic devices, issues of communications. The reality is that we need, I think, to ensure, first and foremost, universal service to Americans across the board.

We can talk about our European neighbors if you want. I would not benchmark any of their systems of mail delivery as a focus to begin the discussion of how do we reform ours. We have the best in the world, from all that I know, and I have spent some time looking at this, and I think the chairman is correct that we must be concerned about what steps we take. Even in our haste to do good, the Congress has been known in the past to make things that are going well disappear, in our haste to show our importance to the process.

The Postal Service, as has been pointed out, for 32 cents, does a hell of a job today. The question is really, how do we improve that without destroying it? Which is where I am in this process.

So the ratemaking process, as best as I can discern, is a process that is overly cumbersome. It takes 10 months, at best. It allows a lot of interested parties to participate in that process in ways that are interesting, to say the least, and the question is, can we expedite that? Can we have a service in the contestable markets, if you will? There could be some flexibility in price to important customers. There are other ways we can look at this. And can we also protect the marketability of those private sector enterprises that have joined and are, in fact, an important part of our way business is done now in this country?

I think there are some issues to work through, but I don't want us to use a sledgehammer to approach this. I think we ought to be

very, very careful that we don't take what is the best Postal Service in the world and, through some notion of economic purity—and I have spent some time at the Wharton School with my friend; there are a lot of interesting theories about how things should work, but this is also the practice.

In practice, the reason why we created public monopolies for a whole range of services in this country was where there was an essential need to make sure the service was provided, and that the profit motive, in and of itself, may not take care of Aunt Minnie's mail. In fact, it may work against her getting her mail in some cases. We created public monopolies to ensure those services.

Whether we are talking about police or fire, I would rank right up there mail delivery, that it is an important public commodity and service that needs to be protected through this reform process. We need to find ways to improve the prospects of a future that is brighter than the one that has been predicted by some. I look forward to working with the chairman in that regard.

Mr. MCHUGH. I thank the gentleman.

I know Professors Kleindorfer and Crew have to leave very shortly.

Mr. KLEINDORFER. Excuse me, sir.

Mr. MCHUGH. As of right now. That is shortly. Thank you for coming.

Mr. FATTAH. They are leaving on Amtrak, another Government supported——

Mr. MCHUGH. I thank the gentleman for his comments. I can assure him our objectives are identical. We will work together, and we are looking forward to that.

In fairness, would anyone like to respond, at least for the record?

Mr. KWOKA. In listening to Congressman Fattah say that those here are speaking to different points, that, of course, I think, is characteristic of, any time you get five or six economists together, you will get at least an equal number of opinions on most any issue; that is right.

But in keeping with his admonishment to focus on the most important issues, I will simply hark back to the conclusion of my statement where I said an important part of any reform is to keep the task simple.

To the degree that this subcommittee wants to take on a range of issues or append a series of other policy reforms at the same time, that, obviously, is its prerogative. But the downside risk of that is that there may be something lost in the process as well.

Universal service need not and should not be sacrificed. Privatization may be a desirable feature in some industries. This, the Postal Service, may or may not be such an enterprise where privatization would work the wonders it has elsewhere.

But those decisions do not have to be made, I think, simultaneously with that which is proposed in H.R. 22. One can simply look at a straightforward comparison between a public enterprise with universal service where ratemaking is governed through cost of service regulation, and compare that very same public enterprise with universal service obligations, and compare its operation under cost of service.

If one can come to a conclusion as to the wisdom of price caps and, in the alternative, to cost of service regulation, then the other issues need not be addressed at the same time.

I, myself, have seen no reason why universal service has to be compromised in any fashion whatsoever. I also share most of my colleagues' views that privatization is a good idea in most enterprises, though I have conducted economic research that shows that in some other utility areas that it is not unambiguously always preferable.

I think there are some reasons why public enterprise, as the Congressman stated, may serve the public interest considerably better under circumstances that many of us can identify. So I would second the notion that focus on the narrower issue of which regulatory regime is superior is one that can be done in isolation from some other policy reforms that others may choose at a different time.

Mr. MCHUGH. Thank you.

Mr. Sidak.

Mr. SIDAK. Mr. Chairman, I would just add that when you are looking at the different regulatory regimes, don't forget competition. One option that certainly is available to Congress is to narrow or repeal the statutory monopolies that currently exist and to facilitate competitive services in those areas that currently are limited to the operation of the Postal Service.

I also agree that universal service is not something that has to be sacrificed. Speaking for myself, I have never been elected to public office; so it is not my place to say what the level of the universal service should be. But the role of an economist is to say, once the policymakers make that call, how you can deliver that level of public service in the most efficient way.

That is why it would be useful to consider, for example, putting out to competitive bidding delivery to high-cost areas. Who can provide service to Montana with the least amount of subside. Do it the same way that we put out all forms of Government contracts to private providers who, on the basis of price and quality, can deliver the services.

Mr. MCHUGH. Just let me say a couple of things about the intent of the bill. We are attempting to recognize, that while giving flexibilities, and allowing the Postal Service to compete, to, in fairness, require them to compete, we do narrow the monopoly to some degree. I am sure it is not as deep and as extreme as you and perhaps others would like. I understand that. We could talk about that further at another time.

But I think the point of your comment is not lost upon us. I understand that, and I think it is well founded.

Dr. Popkin.

Mr. POPKIN. I just wanted to make a comment on the competitive model, and it is this: I can see the competitive model working very well. In fact, in the example that Mr. Sidak used, it was a model where somebody came in and did the work or competes or delivers with the Postal Service. I can see that. That is not hard to envision in your mind.

What I find hard to envision is what the Postal Service buys in return, unless it can turn itself into a Microsoft or some Internet

provider or something like that. I think as far as these competitive products that we talk about, that the Postal Service in certain areas would be competitive, but I don't see at this point what those areas are.

So it seems to me that the competitive model runs the risk of taking more away from the Postal Service than it puts back.

Mr. MCHUGH. Again, and there is neither the time nor really the need to get into debate about that, the theory of what you are buying is flexibility, the lack of which, as I think you heard Dr. Kleindorfer say, has in his views—and I share those views—some rather dire long-term consequences of the decrease in regulatory burden that attends part of the PRC procedures.

You also have the flexibility to introduce new products that at least the postal administration feels is important to be able to change as the environment changes. You could argue this bill doesn't do that, that either that is not necessary, but that in theory is what is being bought here. Whether it is fair purchase is the issue; I understand that.

Dr. Rose.

Mr. ROSE. First of all, let me just chime in with what Mr. Sidak and Dr. Kwoka said on the issue of universal service. I think Mr. Sidak was saying earlier, on the point of utilities, that is not really a conflicting goal. You can have lots of competition in those services that are competitive and still meet your universal service standards. That has not been a problem. Once you have decided that is what you wanted, then you should go ahead with that.

But I want to go back to a point I think Mr. Fattah was also saying. He was also saying something about making it simpler. This kind of gets back to the price cap, which I thought was the original intent of the hearing today.

Mr. MCHUGH. We sometimes lose our way.

Mr. ROSE. Obviously, universal service is very important. Making it simple though, I think if that is the objective, as I made in my opening remarks—if the objective is to make it simpler, something simpler than cost of service, then price caps is probably your answer. If the objective is to lower costs, then that is what I am skeptical of. I don't think you are going to get that.

Let me say that critics of price caps will often point out, it is just as expensive or costly to do that as it is cost of service. I think that is true in the beginning, when you first get them running. But once it is running, the administrative costs do tend to be lower, and they can function quite well.

I can't make a prediction if that would be true in the Postal Service, but just from our experience in telecom in particular, once they are up and running, they are a little bit simpler.

Mr. MCHUGH. Mr. Davis has been very patient, sir. Thank you. I am happy to yield to however belated that yielding might be.

Mr. DAVIS. Thank you very much, Mr. Chairman. I certainly appreciate the opportunity.

I would like to make just a couple of comments based upon the discussion. It seems to me that a great deal of the suppositions relative to the utilization of price caps have centered around the experiences of public utilities, and I am not absolutely certain of the similarity or dissimilarity of the Postal Service System with that

of some of the other entities that we have designated as being public utilities and the other aspect of that as well.

I am not sure where the role of the consumer really fits. Even when we have used other public utilities as an example, there has always been a need or a feeling on the part of consumers that in some instances they were being shafted, left out, or there was a need for some recourse. That aspect concerns me a bit.

Also, when we talk about further privatization—and I am one of those individuals who don't necessarily believe that privatization is a panacea for everything that ails us, that all you have got to do is privatize it and all of a sudden, whatever the problems, whatever the needs, whatever the differences, whatever the difficulties are, they go away, or that every time we talk about reform that it means we are going to improve.

Sometimes reform simply means to change, but not necessarily to improve. Sometimes actually it even will make matters worse rather than better.

I guess the one question that I wanted to raise is, can we really see the impact of further privatization as it relates to the Postal Service? And I don't think you can discuss one aspect without the other. I come from a school of thought that says, unless it is broken, I am not sure that it really needs to be fixed, that certainly you need to keep looking at it, you need to analyze it, you need to try and project what the future will bring.

So my one question is, what are we trying to really fix? What? What are we actually trying to fix? I know what we are trying to change, but what are we trying to fix?

The other question would be, what impact would privatization perhaps have on the ability to provide the universal service that I think everybody has indicated is a key component of the system and has to continue if the system is to work?

Mr. MCHUGH. Can we just establish for the record before they respond that your question vis-a-vis privatization, I assume, is based upon some of the comments here today, and not with respect to H.R. 22, because that bill does not privatize?

Mr. DAVIS. That is correct.

Mr. MCHUGH. Thank you.

Gentlemen.

Mr. KWOKA. Let me address in particular your question, Congressman, with regard to what it is that ratemaking reform is striving to fix, as you say.

In the industries where price caps and other forms of incentive regulation have been put in place, in many instances what has motivated or prompted those changes has been precisely what I think has prompted H.R. 22, looking ahead and envisioning greater difficulties with conventional ratemaking procedures and a future that is subject to greater uncertainty, to more technological change, to dramatic shifts in demographics and other features that put ever-increasing pressures on traditional rate making procedures.

When price caps were put in place for AT&T and the local exchange carriers and for electric utilities at the State level, in many instances there wasn't necessarily a crisis that happened or any particular issue that needed to be fixed at the time. Rather, what was intended was to establish in advance of any such crisis a rate

structure or rate-setting procedure which would be more flexible and adaptable to changes that everyone could foresee.

At the same time, your concern about what is in it for the consumer has been very much at the forefront of the minds of most regulatory commissions at both the Federal and State levels.

The intent in the case of the Postal Service could be stated—I wouldn't presume to state what it, in fact, is but could be stated as follows: The chart that Dr. Popkin showed indicating what the postal price rate of change was over the past 20 years or so. The intent of price caps would be to decelerate that rate of increase. Wherever that line lies relative to CPI or CPI for services, the intent would be to decelerate its further increase.

In particular, if there is concern over the 32-cent stamp, the Aunt Minnie services, or services to rural or any inner-city areas that are particularly vulnerable to cross pressures and other such impediments, those can be separately capped or put in baskets, as they were in the case of the telecommunications industry.

Local residential dial-up service was capped separately so as to ensure that there was no rebalancing of higher rates to those consumers for the benefit of lower rates to others.

Price caps allow, in short, to maintain or improve on any structure of prices the rate of return regulation does and then to offer price decreases on average and perhaps price decreases targeted to particular consumers.

So the intent, in short, would be as it was in these other regimes, to introduce pressures for cost efficiency and to moderate rates of price increase and to offer perhaps particular protections for those prices and those services that were seen as socially most important.

Mr. MCHUGH. Dr. Rose.

Mr. ROSE. Let me try to answer your first question, which I think was, what is the difference?

There is a significant difference between utilities, electric utilities, telecom, gas, and postal customers. That is true, and I acknowledge that. But the electric utilities and gas and telephone were all regulated by cost of service regulation historically, and for a number of years now, 20-some years, the Postal Service has been regulated in a similar way.

Now in the last 10 years, the telecom and the others a little lagging behind have been evolving into price cap regulation, and I agree with all of the advantages that Dr. Kwoka mentioned as there being with that. That is the reason for the change.

So the idea is to just try to form a similarly regulated industry rather than trying to say these are exactly the same, and therefore it is exactly transferable.

If you are going to adopt a price cap approach, as I tried to point out, where some of those differences are, like, since it is a nonprofit organization, the motivation is different, you will have to come up with something, a means of adopting it to Postal Service regulation. You can't take it wholesale from the utility side.

But there are lessons that we have learned in the utility side that I think are transferable and probably shouldn't be lost. That is an advantage that I think you have now, that is to learn something from that.

Mr. MCHUGH. Gentlemen. Dr. Popkin.

Mr. POPKIN. I think Professor Kwoka's comments about having an objective—that it is the objective to come out with a price increase that is lower than the one that is in that chart—demonstrates one of my major concerns about the bill, because that is the way people kind of relate to it. It is less than, not more than.

And when you look at an industry that 80 percent of its costs are labor, if anybody wants to bring the postal rate increases down to a lower rate, there is only one way that is going to happen, and that is to further depress the real wages of postal workers. They have already been declining at an annual rate of about 0.5 tenths of 1 percent. That is more than the average private sector worker.

So this is the way people jump once you get price caps in place. They think that the X factor is a one-way factor.

Mr. MCHUGH. OK. In deference to my colleague who posed the question, I want to go to Mr. Sidak, but then I would like to come back to that at some point.

Mr. SIDAK. Thank you.

In terms of what are we trying to fix here, I think it is important to focus on more than just price. There is another dimension to consumer welfare besides price, and that is service quality and innovation.

I am reminded of a remark that Judge Douglas Ginsberg made at the AEI conference that Professor Kleindorfer mentioned earlier, which we held several years ago. Judge Ginsberg analogized the current monopoly provision of letter mail to the old black rotary dial telephone that you used to get from the Bell monopoly in the predivestiture days, before the deregulation of customer premise equipment.

We don't really know what postal services will look like in a more competitive environment where there are higher levels of product innovation. We could see something that is analogous to what happened with the explosion of choices in the kinds of telephones that you could get once the market was open to that. The current homogeneity of the services that are offered by the Postal Service is one cost that consumers bear that could be changed in the future.

Mr. Davis, you also mentioned the concern about trying to fix things that are not broken. I want to reiterate that the monopoly over the mailbox was something that was imposed in 1934. It wasn't the original state of affairs, and it wasn't something that accompanied the Private Express Statutes in the 1840s. Maybe things weren't broken in 1934, when that fix was produced by Congress, and maybe that is a good place to go back and reconsider whether it should be removed today.

Mr. DAVIS. Thank you very much, Mr. Chairman. That pretty much concludes my comments and concerns. It is an issue that I think we must take a real hard look at.

I have gotten more than 500 postcards from constituents of mine——

Mr. MCHUGH. At least they mailed them.

Mr. DAVIS [continuing]. In the last 3 days, and it is an indication that, certainly in this particular area, people are indeed very much concerned about it and they are aware of it, they are watching it,

and they want to make sure their voices are heard and that they have input into the process.

I certainly thank the gentlemen for their testimony and thank you.

Mr. MCHUGH. I thank you.

For those of us who have labored in empty subcommittee rooms, it is nice to have the people's attention. It took us a while to do it, but, by God, we have, for better or worse.

Mr. Popkin, let me return to your comment, both in your opening statement and your response to Mr. Davis, because I would like to prove once and for all why I am not an economist. As I said, I probably don't grasp this, but I am a little constrained to understand how you equate the pricing structure in H.R. 22 to a wage cap.

Certainly there is nothing in there by statute that caps wages. Wages are totally unaffected in the language of the bill, unlike certain pricings that are held to an index to be determined. Wages are not in any way constrained to be at or below that index. So your concern can't be legal because there is no legal component of the bill that does that.

Do you agree with that statement? Are we together so far?

Mr. POPKIN. Yes.

Mr. MCHUGH. OK. Second of all, the intent—and we can disagree with the effect—but the intent in the bill has always been to allow the Postal Service to enter more effectively into markets that will provide them at least the opportunity in a competitive atmosphere to increase their market share.

I thought I understood you to say in your opening comments, particularly with respect to the Postal Service's performance in recent years, that market share has been growing, and that is important. Market share means increased revenues, which means a greater part of the pie.

I do know a little bit about wage negotiations. I was at that level at city management for 5 years and have been at the bargaining table, and I know how unions and employee groups are very effective in determining revenue pools. So the intent of the bill is to provide greater access to revenues and greater ability to compete, which I assume would be good.

But the thing that I am most pressed to understand is, you spent a lot of time very effectively on your chart showing how at least APWU, one bargaining unit, has had their wages demonstrably below the CPI index year after year, and then express concern that somehow the CPI index would constrain your wages. How can you argue that when you have not been at CPI to begin with?

Mr. POPKIN. Let me just clarify a point about the use of APWU productivity. I think a paper of Laurits Christiansen's was circulated today from the U.S. Postal Service, and that shows total factor productivity, the whole post office, to have risen faster than total factor productivity in the private sector.

So my choice of the APWU doesn't bias that conclusion of postal productivity. I wanted to clarify that for the record.

Mr. MCHUGH. I appreciate that. I used it because you did.

Mr. POPKIN. The concern that I have that the price cap, if there are reasons such as mismanagement that lead the Postal Service to have performance that isn't as good as the private sector, and

therefore actually there would be a tendency for its prices to rise faster than the CPI—which, incidentally, I don't think is the right standard, I think the service sector CPI is.

But if that happens, it is quite likely that the reaction to that within the Postal Service would be to—and we have heard it before—cut out Saturday mail, do those kinds of things to cut into jobs, or, alternatively, to take a different posture at the bargaining table.

I am saying these are the economic consequences that could flow from this. And the likelihood that they will flow from it is increased the minute you get a cap, because people are talking about an X factor. The Postal Service calls it a stretch factor, but it all points in the same direction.

It puts even more pressure on the Postal Service, and that's really my concern, that a labor-intensive industry, 80 percent of costs are labor, there's no room. In the telephone industry, they have 76 percent of costs that they can also work with. In the Postal Service, they only have 20 percent of costs that they can work with without having to impinge on labor's compensation or the number of jobs. So I am not asserting this as a fact, that it's going to—certainly that this is going to obtain in the future, but I can see that all the preconditions are there for that sort of thing. That could evolve. That's not an unlikely scenario, in my view.

Mr. MCHUGH. Well, listen, I am in politics. I accept a lot of scenarios, perhaps unwisely. Me personally, not yours.

I understand and recognize what you are stating. I don't, frankly, think it's any more realistic than what is happening today, and as I said, most importantly, and the reason you have contracts is that those are binding. There's nothing in this bill, that's what I want to make clear, there's nothing in this bill that produces that de facto.

But your comments bring up a point that was a theme that was present amongst all the presenters, whether they felt price caps were a 10, on a scale of 1 to 10, or whether they thought it was a 1 or below, and that is the issue of residual claimants. How do you ingrain into a price setting structure as proposed in H.R. 22 vested interests, to use perhaps a more common phrase to some of us, that will drive the Postal Service toward increased efficiencies, economies, to make sure standards of efficiency are maintained? Because the Postal Service in its current structure is rather unique versus where price caps have been tried in other industries. I think we all agree on that.

Our intent was to have the role of what economists call residual claimants be played by, No. 1, a strong regulator—we give, I think, substantial new powers to the Rate Commission—and two, by the institution of profit sharing at all levels and through the work force from top to bottom, which is currently not the case.

The question I would have for you, gentlemen, and we will pose it in writing to Messrs. Crew and Kleindorfer because I would be very interested in their comments, since, while they endorsed price caps, they particularly had this concern. I would like to have your comments, forgetting for the moment whether price caps are the right or wrong thing to do, how likely is our substitute residual

claimants' entities to provide the traditional service or traditional function?

Why don't we begin with Mr. Sidak, just to change things.

Mr. SIDAK. Thank you. Let me talk about the profit-sharing component first. It's true that a profit-sharing plan as envisioned in section 3783(e) would create incentives on the upside. You could do that even more extensively through share ownership, though. So it's in the right direction, but the magnitude is not as great as if there were tradeable shares.

I am concerned about downside losses. It's true that profit sharing allows management and employees to share in profits. But is there a mechanism for penalizing substandard performance as there is in a private corporation, where the board of directors quickly feels heat from shareholders and, even in some very prestigious American corporations, replaces the CEO?

With respect to the strong regulator, I certainly endorse efforts to give the Postal Rate Commission more of the kinds of powers that you would find in a typical State public utility commission or the Federal Communications Commission or FERC. I endorse that 100 percent.

Mr. MCHUGH. OK. Dr. Popkin.

Mr. POPKIN. Well, I think—I am also concerned about something like profit-sharing arrangements, but from a different, for a different reason.

It's my experience that there are a lot of people at work every day who really don't want to share risk. They would rather have a certain salary rather than variable salaries. Because it could work that you reduce salaries, I suppose. So I think there would be that issue to consider, that not everybody wants to be an owner. And so I think that that's a disadvantage.

The other thing that concerns me is it now seems as though some—while some powers in this bill would be taken away from the PRC, I am concerned about the loss to the Postal Service of its ability to set revenues, which gets back the cost of service and ultimately that gets you to a situation where I think perhaps you really end up relying more on the PRC, because they are going to be the sole monitors of the quality of service. And I would assume that if the quality of service is—if in their view the quality of service is deteriorating, then they have got to make the X factor positive, it has to be an add-on to the inflation rate.

Is that the logic to the bill, I guess is my sort of reaction to it? So even though the PRC is being made less intrusive on a day-to-day rate-setting basis by a price cap, you are giving it a lot of power in the area of determining the quality of service and what kind of X factor is necessary to adjust for their perception of the quality of service.

Mr. MCHUGH. You are right to the extent—you are right in a lot of ways, but on this point you are right, the X factor could indeed be a plus. Everyone assumes it will be a minus, and I think logically under most circumstances it will be, but it could technically and legally be a plus.

However, the bill I think is pretty clear in its designation of the authority of the Postal Rate Commission to suspend profits which would result from a degradation specifically of service and presum-

ably productivity. A plus would be more exogenous to the extent that things are going on in the economy that affect it outside the Postal Service.

But you raise a point about expanded powers, and there are expanded powers. We give them an IG, we give them the right of subpoena. It goes back to our intent, to try to have the regulator serve in some function as a residual claimant.

So I continue down the line for Dr. Rose. Profit sharing, is that a good enough residual claimant?

Mr. ROSE. The idea that the PRC will act in a stronger manner than they are now and given these expanded powers, the way you say it is acting as a surrogate for the marketplace. That sounds very familiar to me as the logic behind cost of service regulation, not price cap regulation. In fact, the whole idea of price cap was to get away from that and have less intrusiveness in looking at the cost structures of the utility. The idea of the price cap was to have a way to give better incentives for the utility to act on its own behalf that would be in a way that is consistent with the interests of the public. That was the general logic. The whole cost of service theory was that the regulator was the stand-in for the market.

So when you phrase it that way, it sounds more like cost of service than the price caps. And there may be reasons to expand it, it may be too weak now, I can't comment on that. I am only commenting on the idea of relating to the price cap, not what the PRC does today.

On the profit sharing, it looked to me a little on the weak side. There were certain provisions it had to go through and be divided, and I suggested in my written testimony perhaps something like a base salary and a bonus where the bonus amount is adjusted, that kind of arrangement, or perhaps even a noncash option as well, maybe a way to provide some kind of a bonus.

I guess I am with Greg Sidak on one point. There was a phrase that really stood out in H.R. 22 for me that kind of got me started along these lines, and I wrote it down. "To restore the Postal Service to financial soundness." In other words I didn't write down the section, I think it's in my testimony—that the PRC was allowed to adjust the adjustment factor, change the adjustment factor to, "restore the Postal Service to fiscal soundness." That's limiting the downside, a private firm of course can lose the whole enterprise, they can simply go under. It's not unusual for utilities to even go into bankruptcy. Receivership is rare but bankruptcy is not uncommon.

So that idea that there's a serious downside and a heavy price to pay for the stockholders who don't like that happening to their company, they are protected from it. There's an asymmetry in that sense, there's a little bit of upside and no real downside.

And as I pointed out in the paper, I am not suggesting you take that phrase out because I don't think anybody wants the Postal Service to go under, but perhaps there's a way of linking it to the bonus. You never get below your base salary but you don't get the bonus if it turns out that quality of service was degraded, something along those lines.

Mr. MCHUGH. Interesting, thank you. Dr. Kwoka.

Mr. KWOKA. I think in asking this question about the residual claimant you have really identified the key question before everybody in this process. The question after all is not whether price caps can and do work, we know they can; the question is whether they can be made to work in the context of the Postal Service which has this distinctively different characteristic. That's not to say there aren't bad price cap plans. Anybody can devise one that doesn't work.

But the truth of the matter is the determination of X factors and proper baskets and all of the rest are technical issues. While there wouldn't be necessarily agreement, these are subject to routine economic and policy analysis, and the plan, the one in H.R. 22 or modified in some way, will emerge from that process.

The question is really whether taking the trappings of all price cap plans and applying them to the Postal Service will work at all, and that's a theme, of course, sounded by most of my colleagues here.

I am unaware of any other context, certainly in this country nor in others, that price caps have been applied to public enterprises. I am not familiar with that experience. I have asked a number of other people as well to see if my understanding was incomplete. I'm not aware of any such experience. That may say something. It certainly raises a caution about its applicability and its prospects for success. I am not nearly as pessimistic. In fact, I am not pessimistic at all, necessarily about the ability to adapt a plan for public enterprise, for reasons I will mention in a moment.

But particularly with regard to your points—the regulator as residual claimant and the ability of profit sharing to serve its role—I would concur with Ken Rose that the role of the regulator in the plan I would hope would not be construed as one of the residual claimant. Indeed, the role of regulator is supposed to be one that withdraws as much as possible from a system where private incentives or profit incentives are put in place of regulatory strictures. That's not to say that some regulatory oversight is not required. We all agree on the quality side there may be no good substitute for vigilance, perhaps greater vigilance.

That said, I think that one ought to see the, stylistically speaking, the magnitude of the regulator's role and the magnitude of profit incentives as moving in opposite directions.

The question here is whether profit incentives will work in this context. Price caps will succeed or fail to the degree that profit incentives work, not to the degree that the regulator plays a more substantial role. That again simply raises the question will profit incentives work, will profit-sharing work in the fashion that's described here. I think that they have good prospects for success if carefully devised.

I am not an expert on pay incentive schemes, on profit-sharing schemes, and I would not offer any detailed comments about the type of plan that would be most suitable. Others know more about that and others, perhaps not here, can and have talked with you all about that. I would simply offer the following several observations.

First, even in private enterprise, even in ordinary garden variety companies that we are all familiar with, the mere fact that it's a

private company does not make the company minimize cost, maximize profit for its shareholders in any inexorable and automatic way. It's for that very reason that even in private enterprises, profit-sharing schemes are employed. If we believed that simply privatization were the key, that it was necessary and sufficient, then we wouldn't need profit-sharing schemes in private enterprise to move management in ways that may be ultimately more consistent with shareholders' interests.

So I would offer the observation that even in private enterprise, profit-sharing schemes have been used successfully to alter the behavior of management in ways that would be consistent with that sought here. I also would offer the observation that, in the context of the Postal Service, there are serious questions about the size of the bonuses, about the symmetry, the upside versus the downside, about who should get that, that is, all levels equally or in some other unequal fashion.

I would say at a minimum that it would be useful to specify a good deal of that in the act so that individuals know exactly the consequences, not in terribly disaggregated detail, but with some specificity, that categories of individuals know what their stake will be in superior performance by the whole of the Postal Service.

I also raised in my written testimony concerns about the possibility, hopefully the reality, that profits will be very large in some particular years: Would one want all of those profits to be distributed, or in the alternative, would some part of the profit go back to the Treasury Department or some other residual claimant in line. So issues of size, of symmetry, of identification of who would be the recipient, all play quite an important role in the design of profit-sharing schemes. And I would urge that that would be an important ingredient in ensuring good prospects for success here.

Mr. MCHUGH. Thank you. Thank you all.

Mr. Davis, any further questions?

Mr. DAVIS. Nothing further.

Mr. MCHUGH. Well, we have been here now for over 2 hours. That's longer than most classes in economics, be it advanced or otherwise, and we do appreciate it. In all sincerity, we could continue here all day and then some, if based on nothing more than the content of all of your statements. It reflected a great deal of work, a great deal of thought and insight, and I deeply appreciate each and every one of you joining us.

I would ask, however, for the opportunity to present you with some written followup questions for the record. I know that's a further imposition on your valuable time, but it would be very useful to us. There are a number of comments made in your individual statements that lead us to want to pursue some issues further. If you would accommodate us, it would be very much appreciated.

[Note.—The book entitled, "Journal of Regulatory Economics," can be found in subcommittee files.]

[The information referred to follows:]

QUESTIONS FOR THE RECORD
FOLLOWING THE HEARING ON APRIL 16, 1997
REGARDING H.R. 22

1. Some witnesses have testified that the price cap index of GDPPI as proposed in H.R. 22 does not take into account the actual input costs of the Postal Service; i.e., labor costs comprising 80 percent of operating costs. For example, Professor Baumol stated that GDPPI is more appropriate for the capital intensive industries where price caps have been applied elsewhere, such as telecommunications, and he argued for consideration of an index that reflects the Postal Service's substantial handicraft components. Further, Dr. Christensen proposed that the Subcommittee consider a blended index of the Employment Cost Index (ECDATE reat reliance on labor. However, other witnesses, such as Mr. Sidak, suggest that basing an index on the Postal Service's capital-labor ratio represents flawed reasoning because the current cost mix is neither profit-maximizing nor cost-minimizing. What are your thoughts regarding selection of an appropriate index, and whether a blended index of ECI and GDPPI is appropriate?

    a. Although the bill proposes that the index be set in statute, how important is it that the regulator have discretion to revisit and adjust the index? What would be an acceptable time frame for the regulator to analyze the market, economic, etc., trends underlying the assumptions used in setting the index?

I do not think there is any set of indexes that would eliminate the reality that a price cap will operate as a wage cap even though the linkage in HR 22 is not explicit. Additionally, Mr. Sidak's reservation underscores the fact that there is no track record or theoretical guidance with price caps in not-for-profit industries, which he refers to as "neither profit maximizing nor cost minimizing."

1. H.R. 22 bases the choice of the adjustment, or "X", factor on various measurable considerations such as costs, revenue, productivity, service quality, and demand. However, other witnesses suggest that the adjustment factor be a pure productivity offset. Yet others argue that the current subjective ratemaking criteria in the statute (e.g., fairness and equity, or the educational, cultural, scientific, and information value of the mail) be retained as the adjustment factor criteria. What are your thoughts regarding the establishment of the adjustment factor solely as a productivity offset? If other factors should be considered, which ones?

    a. H.R. 22 permits a positive or negative adjustment factor, as determined by the Postal Rate Commission after a full and open case. However, some have suggested that a positive adjustment factor should be permitted only under certain conditions and that these conditions should be specifically enumerated under the bill. These witnesses have stated that allowing for a positive

adjustment factor would negate any cost savings and would send the wrong message to postal managers. What are your thoughts in this regard?

b. Some testimony has recommended that a single adjustment factor be set by the Postal Rate Commission and that this would be the same adjustment factor for each basket. These witnesses have observed that setting individual adjustment factors for each basket places the Commission closer to cost-of-service regulatory decisions. However, others suggest that separate adjustment factors for each basket are necessary to take into account the fairness and equity considerations, among others, that many mailers in the noncompetitive category feel are important among baskets. What are your thoughts in this regard? How best can price changes among baskets be seen as fair and equitable? Would the use of price adjustment floors and ceilings be compatible with - or should they replace - the separate adjustment factors for each basket?

c. Dr. Christensen suggests completely hardwiring the price cap formula by not only setting the index in statute, but also selecting the non-farm total factor productivity index published by the government as an annual adjustment factor. What other price cap regimes are completely hardwired, especially in statute? What are the pros and cons of such a suggestion; (for example, Dr. Christensen cites advantages such as the objectivity of the offset and the avoidance of any regulatory meddling)?

d. What considerations should apply in determining the makeup and number of product baskets? In other words, what are the principles that determine the number and content of baskets?

The X or stretch factor, whatever it is called, is insidious. It is clear that the intention of proponents of the bill is to view the factor as one which most likely will be used to make postal rates and, therefore postal wage rates, rise more slowly than inflation. The only circumstance I heard cited in the hearings (see transcript, lines 1906-1916) in which the X factor could be positive is if there is some development affecting the entire U.S. economy, perhaps like a force majeure. In a May 19 speech, Postmaster General Runyon also endorsed this view of the asymmetry of the X factor when he said:

> ***"Legislative reform will hold the Postal Service to a price index for the first time in history. One that virtually assures that overall increases in postal rates--from here on out--will be at or below the rate of inflation."***

Thus, the X factor is certain to be used, except under very limited, circumstances, to insure that increases in the productivity of postal

workers will be passed through to mailers. Mailers will benefit in relation to the volume of mail each deposits in the mailstream.

To me this bill is really about the distribution of income. The bill's mechanisms, and those in price cap formulas posed by others, are designed to redistribute income from rank and file postal workers to mailers, and possibly reward top management with large bonuses for effecting such redistributions.

1. The Subcommittee has heard various points of view on the issue of applying antitrust laws to the Postal Service; what do you see as some of the advantages and disadvantages in applying antitrust statutes to the Postal Service, particularly considering its position as a government entity? To what extent should competitive products of the Postal Service be subject to other laws as applicable to similar products of private companies, such as business practices rules (e.g., Lanham Act), customs laws, etc.?

    a. Relatedly, some witnesses have suggested that the complaint process for rate complaints be strengthened in H.R. 22 to permit consideration of a complaint by the Postal Rate Commission outside of the annual audit, whereas the bill handles rate complaints as part of the Commission's annual audit review. Should rate complaints be handled solely, if at all, within the annual audit? Why or why not?

    b. How would you reconcile a finding by the Commission in the annual audit that the Service's rates are in statutory compliance with a complaint on those rates that comes forward at a later time? Should the Commission's finding in the annual audit that rates are in compliance with the statutory requirements preclude further complaints before the Commission on those rates? Why or why not?

These antitrust questions serve to underscore that in addition to redistributing income, the bill might introduce new legal issues in interpreting the Postal Express Statutes. I think the phrase "postal monopoly" is overused, if not misused. The reality is that the key problem the USPS, and other industries, face is the shift to the use of electronic means of communications. And there is no price and, hence no wage rate at which users of E-MAIL will shift back to letter mail. Moreover, the fact that the postal service is impacted by new technologies offered by private, profit-making companies demonstrates clearly that the USPS operates in "contestable markets." Professor Baumol has shown that under such circumstances, market outcomes approximate those of perfect competition. So, de facto, the USPS is not wielding monopoly power.

1. There is a great deal of concern, under the present system, regarding possible cross-subsidization. How does price cap regulation address this particular concern?

    a. Do you feel it is valid to say that under the existing cost-of-service type of ratemaking, the Postal Service is more likely to overprice its monopoly products and services to subsidize its competitive items?

    b. How true is it that cross-subsidies generally reduce a firm's profitability in the long-term?

    c. What are the best ways to insure against cross-subsidization of competitive products from captive customers? In addition to the price cap itself, the requirement that competitive products cover costs and contribute a reasonable amount to overhead, and antitrust action, H.R. 22 authorizes the Postal Rate Commission to require that up to 50 percent of all profits in any given year be applied to limit or reduce prices for non-competitive products when the Commission's annual audit finds that non-competitive prices exceeded the cap, or that competitive ones were not covering costs or contributing reasonably to overhead. Are these disincentives enough; what should be the sanctions if the Commission finds evidence that the Service is cross-subsidizing?

    d. To what extent should Congress limit price discrimination in a commercial activity like postal service where Congress has limited competitive alternatives for buyers through the statutory monopoly? At what point is price discrimination "unfair" or "unreasonable" in a restricted market?

    e. Currently, HR 22 requires each product in the competitive category of mail to cover its attributable costs plus make a reasonable contribution to overhead. To what extent should Congress require the Postal Service to recover a share of overhead ("institutional costs") and cost of capital from its competitive products collectively? Theoretically, the Postal Service and potentially mailers will benefit if the Postal Service earns one dollar in marginal revenues from competitive markets, i.e., without recovery of any overhead. Likewise, it may be that markets will be distorted and private companies disadvantaged if the Postal Service can compete without the discipline of recovering a fair share of overhead in competitive markets. How should Congress strike a balance between these positions?

    f. If Congress requires the Postal Service to recover a share of overhead ("institutional costs") and cost of capital from its competitive products collectively and otherwise comply with the same laws as private competitors,

is it reasonable to hope that over time the Postal Service's participation in competitive markets will create an incentive to increase its efficiency in non-competitive markets to the same standards as private industry? Or will the price cap mechanism -- on its own – help increase the Service's efficiency in non-competitive markets without expecting these changes to come from additional requirements on competitive products?

It seems cross-subsidies are a fact of life. Ironically legislation in the telecommunications industry designed to reduce some cross subsidies seems to be creating others. For example, cable TV subscribers in Montgomery County, Maryland, are facing a new rate increase allowed by the recent Congressional telecommunications bill. The rate increase has been justified partly by the cost of making a previously optional sports channel part of a set package of service. But there are viewers who do not watch the sports channel and they will end up subsidizing those who do.

Since cross-subsidization is pervasive, it is probably sensible to ask what purpose is served by it. In the case of the USPS, cross subsidization serves the important purpose of assuring universal service at uniform rates. In doing so, it binds the country together, like the Interstate Highway System. This principle of universal service at uniform rates is also likely to be embodied in laws providing for the provision of internet communications by assuring that small towns, inner cities and rural areas have access to internet resources. The USPS has served very well its function of providing the nation with universal service at uniform rates. There may be cross-subsidization, but it lets the USPS serve the needs of the nation.

1. The Subcommittee has heard differing views on the need to incorporate oversight of the quality of service in a price cap framework. H.R. 22 includes this review of service performance in the annual audit by the Postal Rate Commission. What are your thoughts on how, if at all, the Postal Service's achievement of its delivery service standards should be overseen in a price cap regime? Should the Commission also have a role in setting those service standards?

   I believe the Postal Service has a CPA firm that monitors its service performance. The firm's surveys suggest performance has been improving.

1. H.R. 22 permits the Postal Service to experiment with new products and services. How important is this testing authority to an incentive-based regulatory system, and how much freedom should the Postal Service enjoy in testing new products? How

much oversight is necessary, particularly to guard against cross-subsidization? For example, what role should a regulator play in the introduction of new products or services by a regulated entity?

a. Who should determine the placement of new products into price cap baskets; the Postal Service or the Postal Rate Commission?

b. Should the Postal Service be allowed to provide non-postal services like financial services, electronic postmarks, T-shirts, etc.? Why or why not? If so, under what conditions should they be provided? Can non-postal ventures help underwrite the costs of universal service?

With respect to developing and testing new products, the fundamental issue is not cross-subsidization in the traditional sense. It is whether such development and testing diverts management from its primary mission of accepting, processing, and distributing the mail in a timely way.

The focus of this question on new products, and the lack of focus on this or any other question about the "competitive market basket" proposed in HR 22 is worth noting. It underscores the answer to question 2 above--that this bill is really about wage caps and income redistribution.

1. Are there specific issues that the Subcommittee should consider when requiring the baseline rate case (H.R. 22 requires a new rate case in order to provide "fresh" rates for the price cap regime if rates were not set or in the process of being set within 18 months of enactment)? Should the Postal Service continue to have sole authority to set its revenue requirement for this last omnibus rate case; are there any specific items that should be built into this particular revenue requirement?

   a. What have been some of the more common parameters utilized in other price cap regimes to insure that the new system is established correctly and "gets off on the right foot?"

   b. Recognizing that existing law requires the Postal Service to operate under a break-even mandate, the current ratesetting process allows for additional revenue in the rate structure to cover contingencies as well as to recover prior years' losses. Should these additional revenue provisions be included for this final rate case? Why or why not?

This question, especially part *a* reflects, once again, the experimental character of applying price caps and X factors to postal rates. The

question also illuminates the role reversal in HR 22. It would lead to the PRC's having the dominant role in setting revenue requirements while the USPS will play the PRC's role of setting relative postal rates for classes, subclasses, and rate categories, the opposite of the way the system works now.

1. How often should the Postal Service be allowed to increase prices that are subject to the rate cap? H.R. 22 proposes that the Service be permitted once-yearly price increases. Is this appropriate? Should the rate cap be cumulative in nature in that the Postal Service would be allowed to make up for lost increases if it decides to forego a rate increase in one or more years, subject to the cumulative cap?

    a. At what level of the rate schedule should the cap apply? H.R. 22 would apply the rate cap to the subclass level in each basket, thereby permitting the Postal Service the ability to average rate increases among rate categories within a subclass. Should such averaging be restricted through price bands? If so, how?

The frequency of rate increases has long been an issue. The issue is whether there should be relatively infrequent large increases or smaller, but more frequent (annual), adjustments. The USPS wants to avoid "sticker shock," the infrequent, and therefore often necessarily double digit rate increases that have occurred in the past. Of course, mailers often fail to recognize that large increases may only reflect the number of years between rates cases, spans which have risen to unprecedented levels since 1990. But if mailers would rather have more frequent, smaller stamp price adjustments, the PRC has indicated its willingness to hear omnibus rate cases that call for phasing in rate increases over several years. A price cap or indexation mechanism is not necessary to achieve the objective of smaller, more frequent price adjustments.

1. H.R. 22 would allow for an "exigency case" should the Postal Service find that it faces severe financial exigencies and a change in the adjustment factors is needed to restore the Service to fiscal soundness. If the Postal Service requests such a case, the Postal Rate Commission would then decide whether or not to change the adjustment factors that apply during the then current 5 year ratemaking cycle. What are your thoughts on this provision? Under what circumstances, if any, should an exigency case be allowed? What sanctions, if any, should be applied if the Postal Service would seek additional revenue under this procedure?

    a. Instead of the exigency case approach, some witnesses have suggested that the statute specify that the rate cap only be adjusted for specific financial burdens placed on the Postal Service outside of its control, such as Congressional

budgetary obligations. How should the rate cap formula deal with such emergencies? How specific should the statute be regarding the Commission's determinations of exigent costs?

This question arises because HR 22 takes the setting of revenues requirements away from the USPS. It also reemphasizes the foreseeable, and objectionable consequence of HR 22 which is to choose values for the X factor asymmetrically--i.e., usually X factors that are deductions from the inflation rate. That assures that X factors will operate to redistribute income from postal workers to mailers, and that postal workers will not benefit from their improved efficiency.

1. Are there particular practices that have been noticed in other industries using price caps that allow the regulated company over time to attempt to dilute the desired incentives and reduce the potential for cost reductions that the regulator, in turn, should be aware of and specifically monitor?

This question seems to confirm the response given to question 4 above. Namely, cross-subsidies do not go away; the beneficiaries merely change.

1. Assuming "honest, efficient, and economical management" (the statutory standard in Section 3621 of Title 39) of the Postal Service, how large of a statutory postal monopoly is needed to sustain the current level of universal postal service? How can this question be answered? Do we first need to define universal service? Why or why not? If so, how would you suggest that the nation define universal service in the postal services context?

This is precisely one of the questions that should have been asked before the bill was introduced. In general, the bill lacks quantification of the problems it seeks to address and an analysis of how the bill will affect postal revenues, volumes, prices, wages and employment.

2. To what extent do "universal service" obligations set by Congress impose additional costs that the Postal Service would not normally and reasonably incur if operated as a private business? How can this question be answered?

One way is to ask Americans in small cities and rural areas to quantify the effect on them of the loss of rail and bus service and the rise in cost per mile of air travel once transportation providers were allowed to terminate service to many places. Another would be to ask inner city residents to quantify their loss if telephone companies were no longer

required to include them in the local loop. The same kind of question could be raised with respect to gas, electric, water, etc.

3. To what extent could the costs of the universal service obligation be financed by payments from a "universal service" trust fund, such as occurs with the universal service fund in telecommunications?

   Given answer to 12 above, it is difficult to see how such a fund could be applied to the mail. In the absence of HR 22, no such fund would even be contemplated.

4. To what extent could Congress reduce the costs of universal service by limiting the uniform rate requirement for letters to single piece letters? Are there any public interest benefits associated with a statutory requirement for uniform rates for *bulk* letters sent by businesses and organizations?

   Apparently, this question envisions dropping the uniform rate requirement for prebarcoded, first-class letters put by the mailstream in large-volume mailers who receive prebarcoding discounts. Such rates, already low, would no longer have to be uniform; rates to cities could be lower than those to sparsely populated areas. Some mailers would end up paying more, and others less. Without further study, it is so hard to guess whether the average price would rise or fall. It would appear that large mailers to large cities would benefit at the expense of small mailers and those who mail to nonurban places.

5. Generally speaking, what are the overall costs and benefits of our current approach to regulating postal services in the United States? For example, what are the economic costs resulting from the statutory postal monopoly and related postal laws that limit competition? What are the economic benefits derived from such accomplishments as universal service?

   This question is partly empirical, partly national policy. It should be asked but the answer would require extensive work and public debate.

6. Congress enacted the private express statutes in 1845, long before "universal service" was achieved in the United States (about 1915). What economic evidence supports the conclusion that universal service depends on the continuation of the private express statutes?

   It seems clear that universal service depends intrinsically of the existence of the private express statutes. Otherwise, private businesses would cream-skim the profitable routes. The cost of mail service to high

cost areas--inner cities, small towns, and rural America--would rise to very high levels and in some areas service might cease altogether.

7. One aspect of the statutory monopoly is the mailbox prohibition. H.R. 22 provides for a limited demonstration project to test broadening access to the mailbox, although H.R. 22 mandates that the test permit citizens to opt out of the test. This demonstration project is primarily intended to test the idea of giving the citizen a modicum of control over their own mailbox. The citizen, and not the government, would decide on their own whether or not they want others, in addition to the Postal Service, putting mail in the mailbox. To what extent, and based on what evidence, is the mailbox prohibition necessary to provide universal service?

   The mailbox prohibition undoubtedly prevents certain types of cream-skimming. It should be opposed for that reason alone. It is also likely that most households would reject opening their mailboxes on even a "test" basis. I recall seeing at least one mailers' group object to giving the householder the right to opt out of this proposed demonstration project. If so, mailers must fear adverse consequences from "householders' choice."

8. H.R. 22 proposes that the scope of the Postal Service's monopoly over the delivery of letter mail be restricted to letters costing less than 2 dollars. What evidence are you aware of, if any, that would indicate how this change would impact the Postal Service, particularly in terms of its revenue?

   The $3 limit has been in effect since 1979. Adjusted for inflation, it is already only a $1.36 limit. It should be raised to $6.62 to stay even with inflation and, not be lowered. Lowering it to $2 would bring the limit below $1, adjusted for inflation. The most immediate and obvious loss from lowering the limit below $3 would be priority mail which costs $3. This is a rapidly growing USPS mailstream segment.

   USPS is already using private contractors for priority mail work. It would be a short step for the contractors to take over the whole operation. The USPS opposes, as you know, the provision in HR 22 that places priority mail in the competitive basket, so it probably also objects to dropping the $3 limit.

1. You conclude in your testimony that "wages do not seem to be a problem for the U.S. ratepayer." However, as you may know, many in the mailing community have testified that they believe labor costs are a problem. For example, Professors Crew and Kleindorfer cite a study in their testimony that purportedly demonstrates a pay premium for postal employees over similarly situated employees in the private sector.

Many in the mailing community also cite this study, among other data. (According to the Professors' statement: "Perloff and Wachter have estimated the magnitude of the postal employee premium at 28%. See Jeffrey M. Perloff and Michael L. Wachter, 'A Comparative Analysis of Wage Premiums and Industrial Relations in the British Post Office and the United States Postal Service', in M.A. Crew and P.R. Kliendorfer (eds), *Competition and Innovation in Postal Services*, Kluwer Academic Press, Boston, 1991."). How do you explain the disparity in views regarding whether or not wages are a problem?

In the Perloff and Wachter article cited, there is a reference in Table 1, page 118, to an article by Asher and Popkin that comes to the conclusion that for white males in the USPS workforce there is no wage premium. Asher and Popkin concluded that the premium found by Perloff and Wachter reflects the fact that unlike in the USPS, nonwhite men and all women are paid less than white males. Both articles appeared, one after the other, in the academic journal, *Industrial and Labor Relations Review*, October 1984. The editor was presenting two different approaches to measurement that yielded two different conclusions. Since the 1984 articles, three arbitrators have heard testimony on these studies and have not accepted the notion of such a premium. I can say that about the 1994 arbitration drawing on my own experience as a party-appointed arbitrator. Considerable other evidence, supporting the notion that there is indeed comparability, was submitted at those arbitrations, including detailed comparison of wage levels for similar jobs. Indeed, after two days of testimony from Professor Wachter, the panel I was on concluded that the wage rates it set were consistent with statutory provisions concerning comparability. I feel confident professionally in disagreeing with Perloff and Wachter.

2. You suggest in your testimony that price caps are in effect wage caps for an organization such as the Postal Service. However, in February 1997, the Communica union in the United Kingdom) proposed legislation to turn the British Post Office into an independent corporation. At the centerpiece of this proposal, the British postal workers' union advocated that the monopoly activities of Royal Mail be subject to an RPI-x price cap formula, and that the monopoly activities should be subject to review by an independent regulatory agency. The British postal workers' union stated:

> "The Post Office is a success story....But this success should not be taken for granted – the communications market is changing profoundly and the Post Office must change with it....What this country needs is a postal service that retains its public service ethos whilst being given the

> commercial and financial freedom necessary to grow and prosper in the fiercely competitive communications market of the late 20th century."

Clearly, the British postal workers' union finds that the changing communications marketplace requires increased competitive flexibility for the Post Office – and they conclude that this flexibility can best be obtained through a price cap regime. Do you believe that the British union is proactively looking to cap their own wages, or does the union's proposal suggest that price caps are actually an appropriate structure for a Postal Service to survive – and maintain postal jobs without capping wages – in the communications marketplace of the 20th century?

The Communications Workers Union (CWU) in the UK suggested a price cap because it was addressing two very specific problems. The first is that postal rate increases in the UK are driven by the government's use of the postal service as a source of revenues for the UK treasury. Postal rates in the UK may not have risen at all were it not for this behavior by the government. The second is that there is a European community directive that penalizes postal services in member countries for certain price increases. The CWU is caught between "a rock and a hard place" and made its proposal only as a contribution to the debate in the UK on this issue.

FOLLOWUP QUESTIONS AND RESPONSES OF MR. KWOKA

QUESTIONS FOR THE RECORD
FOLLOWING THE HEARING ON APRIL 16, 1997
REGARDING H.R. 22

1. Some witnesses have testified that the price cap index of GDPPI as proposed in H.R. 22 does not take into account the actual input costs of the Postal Service; i.e., labor costs comprising 80 percent of operating costs. For example, Professor Baumol stated that GDPPI is more appropriate for the capital intensive industries where price caps have been applied elsewhere, such as telecommunications, and he argued for consideration of an index that reflects the Postal Service's substantial handicraft components. Further, Dr. Christensen proposed that the Subcommittee consider a blended index of the Employment Cost Index (ECI) and GDPPI, to better reflect the Service's great reliance on labor. However, other witnesses, such as Mr. Sidak, suggest that basing an index on the Postal Service's capital-labor ratio represents flawed reasoning because the current cost mix is neither profit-maximizing nor cost-minimizing. What are your thoughts regarding selection of an appropriate index, and whether a blended index of ECI and GDPPI is appropriate?

    a. Although the bill proposes that the index be set in statute, how important is it that the regulator have discretion to revisit and adjust the index? What would be an acceptable time frame for the regulator to analyze the market, economic, etc., trends underlying the assumptions used in setting the index?

2. H.R. 22 bases the choice of the adjustment, or "X", factor on various measurable considerations such as costs, revenue, productivity, service quality, and demand. However, other witnesses suggest that the adjustment factor be a pure productivity offset. Yet others argue that the current subjective ratemaking criteria in the statute (e.g., fairness and equity, or the educational, cultural, scientific, and information value of the mail) be retained as the adjustment factor criteria. What are your thoughts regarding the establishment of the adjustment factor solely as a productivity offset? If other factors should be considered, which ones?

    a. H.R. 22 permits a positive or negative adjustment factor, as determined by the Postal Rate Commission after a full and open case. However, some have suggested that a positive adjustment factor should be permitted only under certain conditions and that these conditions should be specifically enumerated under the bill. These witnesses have stated that allowing for a positive adjustment factor would negate any cost savings and would send the wrong message to postal managers. What are your thoughts in this regard?

b. Some testimony has recommended that a single adjustment factor be set by the Postal Rate Commission and that this would be the same adjustment factor for each basket. These witnesses have observed that setting individual adjustment factors for each basket places the Commission closer to cost-of-service regulatory decisions. However, others suggest that separate adjustment factors for each basket are necessary to take into account the fairness and equity considerations, among others, that many mailers in the noncompetitive category feel are important among baskets. What are your thoughts in this regard? How best can price changes among baskets be seen as fair and equitable? Would the use of price adjustment floors and ceilings be compatible with – or should they replace – the separate adjustment factors for each basket?

c. Dr. Christensen suggests completely hardwiring the price cap formula by not only setting the index in statute, but also selecting the non-farm total factor productivity index published by the government as an annual adjustment factor. What other price cap regimes are completely hardwired, especially in statute? What are the pros and cons of such a suggestion; (for example, Dr. Christensen cites advantages such as the objectivity of the offset and the avoidance of any regulatory meddling)?

    i. In your statement you discuss the need for periodic performance reviews to insure that the cap remains accurate and proper and to prevent it from undermining the plan's incentives. To what extent should the regulator have the ability to change the index AND the "x-factor" during this process, or as proposed in H.R. 22, should the index be set in law and the focus during this periodic review process be on adjusting the "x-factor" alone?

d. What considerations should apply in determining the makeup and number of product baskets? In other words, what are the principles that determine the number and content of baskets?

3. The Subcommittee has heard various points of view on the issue of applying antitrust laws to the Postal Service; what do you see as some of the advantages and disadvantages in applying antitrust statutes to the Postal Service, particularly considering its position as a government entity? To what extent should competitive products of the Postal Service be subject to other laws as applicable to similar products of private companies, such as business practices rules (e.g., Lanham Act), customs laws, etc.?

a. Relatedly, some witnesses have suggested that the complaint process for rate complaints be strengthened in H.R. 22 to permit consideration of a complaint by the Postal Rate Commission outside of the annual audit, whereas the bill handles rate complaints as part of the Commission's annual audit review. Should rate complaints be handled solely, if at all, within the annual audit? Why or why not?

b. How would you reconcile a finding by the Commission in the annual audit that the Service's rates are in statutory compliance with a complaint on those rates that comes forward at a later time? Should the Commission's finding in the annual audit that rates are in compliance with the statutory requirements preclude further complaints before the Commission on those rates? Why or why not?

4. There is a great deal of concern, under the present system, regarding possible cross-subsidization. How does price cap regulation address this particular concern?

a. Do you feel it is valid to say that under the existing cost-of-service type of ratemaking, the Postal Service is more likely to overprice its monopoly products and services to subsidize its competitive items?

b. How true is it that cross-subsidies generally reduce a firm's profitability in the long-term?

c. What are the best ways to insure against cross-subsidization of competitive products from captive customers? In addition to the price cap itself, the requirement that competitive products cover costs and contribute a reasonable amount to overhead, and antitrust action, H.R. 22 authorizes the Postal Rate Commission to require that up to 50 percent of all profits in any given year be applied to limit or reduce prices for non-competitive products when the Commission's annual audit finds that non-competitive prices exceeded the cap, or that competitive ones were not covering costs or contributing reasonably to overhead. Are these disincentives enough; what should be the sanctions if the Commission finds evidence that the Service is cross-subsidizing?

d. To what extent should Congress limit price discrimination in a commercial activity like postal service where Congress has limited competitive alternatives for buyers through the statutory monopoly? At what point is price discrimination "unfair" or "unreasonable" in a restricted market?

e. Currently, HR 22 requires each product in the competitive category of mail to cover its attributable costs plus make a reasonable contribution to overhead. To what extent should Congress require the Postal Service to recover a share of overhead ("institutional costs") and cost of capital from its competitive products collectively? Theoretically, the Postal Service and potentially mailers will benefit if the Postal Service earns one dollar in marginal revenues from competitive markets, i.e., without recovery of any overhead. Likewise, it may be that markets will be distorted and private companies disadvantaged if the Postal Service can compete without the discipline of recovering a fair share of overhead in competitive markets. How should Congress strike a balance between these positions?

f. If Congress requires the Postal Service to recover a share of overhead ("institutional costs") and cost of capital from its competitive products collectively and otherwise comply with the same laws as private competitors, is it reasonable to hope that over time the Postal Service's participation in competitive markets will create an incentive to increase its efficiency in non-competitive markets to the same standards as private industry? Or will the price cap mechanism -- on its own – help increase the Service's efficiency in non-competitive markets without expecting these changes to come from additional requirements on competitive products?

5. The Subcommittee has heard differing views on the need to incorporate oversight of the quality of service in a price cap framework. H.R. 22 includes this review of service performance in the annual audit by the Postal Rate Commission. What are your thoughts on how, if at all, the Postal Service's achievement of its delivery service standards should be overseen in a price cap regime? Should the Commission also have a role in setting those service standards?

6. H.R. 22 permits the Postal Service to experiment with new products and services. How important is this testing authority to an incentive-based regulatory system, and how much freedom should the Postal Service enjoy in testing new products? How much oversight is necessary, particularly to guard against cross-subsidization? For example, what role should a regulator play in the introduction of new products or services by a regulated entity?

   a. Who should determine the placement of new products into price cap baskets; the Postal Service or the Postal Rate Commission?

   b. Should the Postal Service be allowed to provide non-postal services like financial services, electronic postmarks, T-shirts, etc.? Why or why not? If

so, under what conditions should they be provided? Can non-postal ventures help underwrite the costs of universal service?

7. Are there specific issues that the Subcommittee should consider when requiring the baseline rate case (H.R. 22 requires a new rate case in order to provide "fresh" rates for the price cap regime if rates were not set or in the process of being set within 18 months of enactment)? Should the Postal Service continue to have sole authority to set its revenue requirement for this last omnibus rate case; are there any specific items that should be built into this particular revenue requirement?

    a. What have been some of the more common parameters utilized in other price cap regimes to insure that the new system is established correctly and "gets off on the right foot?"

    b. Recognizing that existing law requires the Postal Service to operate under a break-even mandate, the current ratesetting process allows for additional revenue in the rate structure to cover contingencies as well as to recover prior years' losses. Should these additional revenue provisions be included for this final rate case? Why or why not?

8. How often should the Postal Service be allowed to increase prices that are subject to the rate cap? H.R. 22 proposes that the Service be permitted once-yearly price increases. Is this appropriate? Should the rate cap be cumulative in nature in that the Postal Service would be allowed to make up for lost increases if it decides to forego a rate increase in one or more years, subject to the cumulative cap?

    a. Please explain more fully your recommendation for an "Actual Price Index" and its application to the Postal Service.

    b. At what level of the rate schedule should the cap apply? H.R. 22 would apply the rate cap to the subclass level in each basket, thereby permitting the Postal Service the ability to average rate increases among rate categories within a subclass. Should such averaging be restricted through price bands? If so, how?

9. H.R. 22 would allow for an "exigency case" should the Postal Service find that it faces severe financial exigencies and a change in the adjustment factors is needed to restore the Service to fiscal soundness. If the Postal Service requests such a case, the Postal Rate Commission would then decide whether or not to change the adjustment factors that apply during the then current 5 year ratemaking cycle. What are your thoughts on this provision? Under what circumstances, if any, should an exigency case be allowed? What sanctions, if any, should be applied if the Postal Service would seek additional revenue under this procedure?

a. Instead of the exigency case approach, some witnesses have suggested that the statute specify that the rate cap only be adjusted for specific financial burdens placed on the Postal Service outside of its control, such as Congressional budgetary obligations. How should the rate cap formula deal with such emergencies? How specific should the statute be regarding the Commission's determinations of exigent costs?

b. Please explain in more detail your thoughts expressed in your testimony regarding treating exogenous costs separately from the index.

10. Are there particular practices that have been noticed in other industries using price caps that allow the regulated company over time to attempt to dilute the desired incentives and reduce the potential for cost reductions that the regulator, in turn, should be aware of and specifically monitor?

11. Assuming "honest, efficient, and economical management" (the statutory standard in Section 3621 of Title 39) of the Postal Service, how large of a statutory postal monopoly is needed to sustain the current level of universal postal service? How can this question be answered? Do we first need to define universal service? Why or why not? If so, how would you suggest that the nation define universal service in the postal services context?

12. To what extent do "universal service" obligations set by Congress impose additional costs that the Postal Service would not normally and reasonably incur if operated as a private business? How can this question be answered?

13. To what extent could the costs of the universal service obligation be financed by payments from a "universal service" trust fund, such as occurs with the universal service fund in telecommunications?

DEPARTMENT OF ECONOMICS

July 1, 1997

Hon. John M. McHugh, Chairman
Subcommittee on the Postal Service
B-349C Rayburn House Office Building
Washington, DC 20515

Dear Congressman McHugh:

I enclose my Responses to the Questions you forwarded to me for the record following Hearings on April 16 regarding H.R. 22. Thank you for the opportunity to testify and to amplify my remarks in these responses.

Sincerely,

John Kwoka

John Kwoka
Professor of Economics

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RESPONSES BY JOHN E. KWOKA, JR.

TO QUESTIONS PURSUANT TO HEARINGS ON H.R. 22

Question 1

GDPPI is the broadest measure of price changes throughout the economy and has therefore been selected as the index of input cost changes for most price cap plans. It was not selected because it perfectly captured the cost experience of any single company or some industry with a particular characteristic (the capital intensity of telecommunications companies or the labor intensity of the Postal Service, for example). In principle, therefore, it may be possible to find or devise a better index, but that is not a straightforward process.

The proposed alternatives to GDPPI for the Postal Service basically combine multiple indexes into some weighted average. Both the constituent indexes and the weights are subject to various reservations. For example, one proposal would combine the Employment Cost Index with GDPPI. But the merits of the ECI for present purposes would need to be established. In addition, the GDPPI would still be used for non-employment costs despite the fact that it was not designed as a nonlabor or capital cost index. Also, if disaggregation is sensible, one could equally well argue for separate indexes for each category of inputs--labor, capital, fuel, materials, etc. There is, in short, no natural stopping point to such disaggregation. A final concern with this formulation is that the use of weights based on the Service's current input mix runs the risk of validating its presently suboptimal mix. Determining the optimal mix would be difficult, to say the least.

For all these reasons, I believe that developing a specific index for the Postal Service would create more problems and controversies than it would solve.

Question 1(a)

If price caps are to avoid the controversies of rate of return regulation and achieve the intended cost efficiencies, their operation should be as free of the prospect of regulatory intervention as possible. The regulator's ability to intervene will engender efforts by the price capped company to influence decisions to its advantage. That, in turn, will defeat the very purposes of price caps: focus on cost efficiency, and administrative simplicity.

Consequently, I would urge once-and-for-all selection of an index, by order or statute, and not entertain pleas for its revision except under conditions of *force majeure*.

Question 2

The theory of price caps is clear on the fact that the X factor should be a pure productivity adjustment. Together with a suitable input cost index, this ensures that price moves from its present level exactly with the change in the company's unit cost. That, in turn, results in a price capthat allows the company to realize the same net income as initially, since its revenues and costs change in lockstep fashion.

Introducing other considerations into the determination of the X factor would create any number of possible problems. First, it would no longer ensure that overall revenues and costs matched. Second, it would open up each rate and rate class to the same kind of on-going debate that characterizes current rate-making. And third, since current rate levels--presumably the point of departure for price caps--already reflect these considerations, use of productivity for future changes in no way suppresses them. (I should note that if current rates are not the point of departure, then different considerations apply.)

I would therefore urge that the X factor be based on the best evidence of likely Postal Service productivity.

Question 2(a)

The theory of price caps implies that the X factor may properly be any number--negative, zero, or positive--depending upon the productivity capabilities of the price capped producer. To date price caps have been applied primarily in cases of companies whose productivity capabilities exceed those of the economy as a whole and hence have negative X factors. In principle, however, companies whose productivity is expected simply to match that of the economy should have a zero offsetting X factor, and those whose productivity truly falls below that should have a positive X factor. Such cases exist among the Regional Electric Companies in the UK.

While a positive X factor may appear to be a weak restraint, it does not "negate any cost savings" if it is correctly chosen. Rather, if that represents the best practice for the company, then it also represents the correct target: There are no hidden cost savings.

I might note that a case can be made for a transitional "Y" factor that might result in a *temporary* positive overall price cap. Y would be some number added to X to reflect legitimate difficulty that the Postal Service might have in achieving the target X value immediately. Y should decline over some relatively brief period of time (say, two years) in accordance with a preset schedule, so as to avoid efforts at extending it.

Question 2(b)

Given my belief that the X factor should reflect Postal Service productivity, the only basis for different X factors among baskets is convincing evidence that productivity differs for the services within each basket. Otherwise, the only reasonable presumption is that the number for overall Postal Service productivity--whatever that may be--best characterizes likely productivity for each basket. As a practical matter, it will be sufficiently challenging to determine a single productivity factor, without embarking on a process of selecting different factors for each basket and its particular combination of individual services.

Floors and ceilings may be desirable ancillary restraints within the overall price cap for a basket insofar as there is concern about the magnitude or speed of likely price changes, or about the net effects of particular price changes on groups of customers or competitors. Floors and ceilings may therefore be appended to any price cap. While they do not substitute for different adjustment factors in the sense of implying different productivity expectations, they do alter the path that prices may take over time.

Question 2(c)

Price cap plans embody maximum incentives for cost efficiency and minimum opportunity for strategic behavior to the extent that their parameters are not easily changed. On the other hand, complete irreversibility is not desirable since parameters will not remain correct forever. The correct balance is a function of how accurate the initial plan design is expected to be: The more accurately parameters are initially set, the longer the interval should be until performance is reviewed and parameters possibly changed. The less confidence one has in the initial choice of parameters, the sooner performance should be reviewed in order to ensure that the objectives are being met.

If "hardwiring" means a price index and adjustment factor reversible only by legislation, that would seem to represent a needlessly high hurdle. The legislative process would not seem well suited to what is ultimately a technical question, and I am not aware of price cap plans that codify such matters into law. On the other hand, it would sabotage the key plan objectives of cost efficiency and simplicity in administration if the price index and adjustment factor were too easily changed or subject to very frequent review.

Question 2(c)(i)

I would urge that GDPPI be selected as the price index and that it be set by statute. The rationale for embedding it in the statute is that the relevant price index does not change over time, and so if correctly determined at the outset, there is no reason for revisiting its choice in the future.

The same cannot be said for the adjustment factor X. Productivity does change over time, and whether it changes or not, more is learned about its actual value from experience. For these reasons, periodic regulatory review is the appropriate mechanism for the X factor. I would urge this not be set by statute but rather be determined as part of periodic, but infrequent, performance reviews.

Question 2(d)

The principles for construction of service baskets are as follows: First, cross-elastic services should be aggregated into the same basket. This allows customer shifting between such services without triggering large changes in weights in different baskets that would allow other prices in each basket to be substantially altered. Combining substitutes also helps ensure that any price increases adversely affecting a particular customer class are accompanied by offsetting reductions in other prices for the same customers.

Second, services facing similar degrees of competition should be combined. Otherwise, price increases on noncompetitiive services can more readily be used to offset declines in prices of services facing competition.

Question 3

There can be little question that government enterprises have both the incentive and ability to engage in anticompetitive practices. Managers--particularly those with financial incentives related to enterprise performance--are likely to undertake pricing and other actions to deter entry, handicap rivals, predate against existing competitors, and so forth. Such antitrust issues have arisen in the electric power industry in cases involving Otter Tail Power and TVA. These possibilities are yet more likely in cases where the enterprise can enter essentially competitive markets, as is contemplated for the Postal Service.

Some standard antitrust penalties may not be very successful in the case of a government enterprise, but there are at least two that may prove effective in the present case. First, a financial penalty can be exacted within an unchanged price cap. That is, the fine would have to be paid from earned revenues, so that the gains that might otherwise have been realized under the cap would be lost to the Service and its employees. Second, injunctions may be issued against the anticompetitive actions by named individuals, who then are subject to criminal prosecution for further violations.

Question 3(a)

Rate complaints should be handled more expeditiously than the annual audit cycle and outside that audit for several reasons. First, swift resolution of complaints benefits all parties to a dispute. By contrast, delays of up to a year for consideration and longer for resolution provide too great an opportunity for strategic behavior by the Postal Service (which gets an automatic one-year waiver for certain conduct) and a corresponding period of possible injury to customers or competitors.

Experience at other agencies suggests that rate complaints may not be infrequent (and, of course, will be more frequent as more competitive markets are entered). It is therefore necessary that criteria and procedures be in place to handle such complaints in an appropriate, systematic, and consistent fashion.

Question 3(b)

One method of reconciling the annual rate determination with subsequent complaints is for the annual determination to create a rebuttable presumption of compliance. This approach would provide a foundation for accepting the rates in the annual determination but it does not preclude later detailed examination in the context of a particular complaint. It also places the burden of rebutting the presumption on the complaining party, as is generally appropriate, but does not require overturning a Commission finding.

Question 4

In principle, price caps completely eliminate the incentive to engage in cross-subsidization. They achieve this by severing the connection between incurred costs and price or revenue, so that misallocating costs for strategic or other reasons does not affect the cap and hence yields no benefit to the company. That said, there are several practical considerations to note.

First, actual price cap plans are never so pure. All entail some implicit if not explicit adjustment possibilities based on company performance, and performance inevitably reflects cost experience. To that extent there will be some (diminished) benefits from cost misallocation.

Second, the decoupling of price from cost under price caps may appear to permit *greater* cross-subsidization as the company is, in fact, free to price without regard to the actual cost of any particular service. That allows seemingly arbitrary pricing by the company, although if ancillary restraints like floors are in place, no true cross-subsidization is likely to occur.

Third, other anticompetitive actions remain equally likely under price caps as under rate of return. Notable among these is discrimination, whereby the incumbent can alter price or quality of some essential service it provides to its competitors. By doing so, it can handicap their conduct and relax their competitive threat.

Question 4(a)

Yes.

Question 4(b)

Under pure price caps cross-subsidies reduce a firm's own profitability, but under rate of return regulation, this practice may indeed be profit-increasing to the company. By forestalling competition and by expanding its rate base, cross-subsidization can elevate long-run profitability. As noted, earlier, price caps in actual practice lie in between these two extremes, depending upon the degree to which price and cost are decoupled.

Question 4(c)

The indicated disincentives should prove adequate to minimize the incidence of cross subsidization. If the Commission nonetheless finds evidence that the Postal Service is cross subsidizing, the same sanctions as suggested for antitrust violations could be applied, namely, financial penalties under the cap or injunctive relief.

Question 4(d)

Every regulated industry engages in price discrimination to some extent. Price discrimination can be an effective device to enhance revenues in a natural monopoly setting, thereby contributing to covering total costs. Properly designed price discrimination may even be even be the most efficient structure of prices that allows the company to break even, that is, the one that minimizes deadweight loss.

But price discrimination may also raise policy concerns. At some point it may result in price differentials that seem excessive ("unfair" or "unreasonable") in their magnitude and burden on particular customer classes. These are inherently policy judgments that fall to the regulator to make.

Question 4(e)

This question makes clear one of the major difficulties associated with Postal Service operation in competitive markets. Such operation would seem to be appropriate (why would Congress or a regulator ever prohibit entry?) and advantageous to customers of both competitive and noncompetitive services. Yet there are a number of inevitable and adverse consequences of such entry and operation--the inherent difficulties of administering the price system, the incentives for the Service to engage in strategic pricing, the deterrence of other entry and distorted development of competitive markets, and the very real possibility that some customers will face higher prices regardless of underlying costs.

It is for these reasons that I have recommended against allowing Postal Service operation in competitive markets, absent convincing evidence of enormous economies of scope. Cost savings of merely "one dollar" may in principle produce benefits, but the costs to the system vastly exceed such minimal gains.

Question 4(f)

Although I do not favor Postal Service operation in competitive markets, I will answer this question based on the stated premise.

If the Postal Service were to operate in competitive markets, this might provide some basis for the Service to understand how best to achieve efficiencies throughout its operations. Yet it must be remembered that price caps by themselves give the Service every incentive for efficiency in noncompetitive services. Moreover, what it learned from exposure to rivals in competitive services would be limited by the comparability of the technology, labor, and management systems between competitive and noncompetitive services. In addition, the difficulties of correctly pricing competitive services might allow the Service to operate there without ever having to match the cost discipline of its rivals. If so, there would be no demonstration effect whatsoever.

Question 5

As I and others testified, quality is a potential Achilles heel for price caps, since the cost incentives of price cap plans may encourage a company to reduce product or service quality. There is circumstantial evidence of such an effect in various price capped markets. For these reasons I would recommend that with guidance from the Service and user groups, the Commission should set objective and measurable standards of performance. It should then require the Service to compile data on these standards on a semiannual basis. This will allow detection of quality problems in a timely manner.

Failure to meet quality standards should be addressed by adminstrative action, that is, by Commission directive that any significant problems be remedied. Formal penalties--fines or inclusion of quality standards in the price cap formula--should be held in reserve if administrative directives do not succeed.

Question 6

The Postal Service should be given the widest possible lattitude in developing and testing legitimately new services within its area of expertise. Development of new services is one of the important incentives of price cap plans, and the record in other industries confirms that price caps do indeed encourage such initiatives. But this lattitude should be subject to certain limitations to ensure that it is employed to the benefit of consumers. First, the new services should be within its area of expertise, not ventures into entirely new and different services where there is no reason to expect the Service to have a comparative advantage. Second, even within its area of expertise, the new services must be legitimate efforts to test market potential and not "fighting brands" intended to counter existing or potential entrants. These criteria should be administered by the Commission.

Third, the pricing of such new services should be brought under the cap at a relatively early point in time, say, within six months. This will encourage concerted efforts by the Service to determine market potential without undue disruption to other services and rivals for a prolonged period of time. If the new product thereafter does not succeed in the market, it can be withdrawn under price cap procedures.

Question 6(a)

The Postal Rate Commission should determine the placement of new products into price cap baskets. The self-interest of the Postal Service makes it an altogether inappropriate entity for rendering this decision.

Question 6(b)

No. Virtually by definition, there are no obvious and significant economies of scope between postal and non-postal services that justify Service provison of the latter. Moreover, as I discussed earlier, Postal Service entry into these unrelated areas creates a host of difficult pricing problems. On balance, therefore, there are costs without benefits to provision of non-postal products, and the appropriate policy seems clear.

Question 7

As I testified, there are a number of reasons to avoid a "baseline rate case" just prior to inauguration of price caps, but if one is to be conducted, it should proceed recognizing the implications of the fact that price caps will follow. More concretly, since the baseline rates will form the basis for future prices under caps, the Postal Service will understand their greater importance and can be expected to seek rates that provide an enduring advantage. In this context, allowing the Service to set its own revenue requirement runs the obvious risk of permanently embedding excessive costs in price caps. Some alternative method of establishing the revenue requirement must be found.

I am not sufficiently familiar with the postal rate case process to propose specific suggestions, but the nature of the possible problems with rate structure are quite clear. The Postal Service will predictably offer low prices for services where it can forsee competition, and insist on higher prices (no doubt offering cost and elasticity justifications) in areas where it will hold an enduring monopoly. Permitting such rebalancing as part of initial rates will also lengthen the period of monopoly control by the Service.

Question 7(a)

In most price cap plans, the point of departure has been pre-existing rates rather than some re-initialization of rates. The reasons are threefold: First, if it were possible to set more appropriate rates than those existing at present, that would presumably already have been done. Hence the most that can be accomplished by a baseline rate case would seem to be replication of standard practice. Second, even that replication may not be possible since, as I have just discussed, resetting baseline rates for price cap purposes raises the stakes for all parties and induces greater strategic behavior. Third, instituting price caps is a sufficient policy challenge by itself. Achieving consensus and support is made more difficult by encumbering the process with additional issues involving current rates.

For these reasons, I would urge a minimal rate case, if at all, and a focus on the going-forward benefits of price caps.

Question 7(b)

The question of recovery of one additional past year's losses is a policy judgment that will not affect the future operation of price caps for the Postal Service (at least not so long as it is clear that this would be the final such recovery allowed). By their very nature, however, contingency reserves are different. They represent allowances for recovery of *future* excess costs, in direct contradiction to the basic premise of price caps that the company be bear the burden of excess costs,

just as it realizes benefits from excess profit. Adoption of contingency reserves is therefore tantamount to the abandonment of price caps and should not be allowed.

Question 8

The frequency of allowed price changes should reflect the likely pace of factors that justifiably influence prices. These are input costs, technology, and demand conditions. To the extent that these do not change quickly and unpredictably, annual price changes would seem entirely appropriate.

Regarding the rate cap itself, this should be cumulative in the sense that the Postal Service should be able to raise prices based on previously unused pricing discretion (up to the current cap). The alternative "use it or lose it" policy would create an incentive for the Service to raise prices to the maximum allowable at each point in time since any foregone pricing discretion would thereafter limit it to a lower rate.

Question 8(a)

My proposed Actual Price Index is intended to conveniently keep track of the Postal Service's current actual price, on the assumption that allowable but currently unused pricing discretion could later be drawn upon. Suppose, for example, the cap foes from an initial index value of 100 to 104 in the following year. Then if the Postal Service chose not to use all of its pricing discretion in the second year, an index of its *actual* prices might be, say, 103. While this is obviously below the cap, it indicates some currently unused pricing discretion that might later be employed. On an on-going basis the API would track actual rates relative to the cap, but also automatically indicate the extent of remaining pricing discretion.

Question 8(b)

Standard practice is for a "cap" to apply to a "basket." This is more than a definitional issues since the criteria for services constituting a basket and the relationship among prices of services within a basket are inextricably related. If the cap is applied only to some disaggregation of a "basket," the latter is not truly a basket since there is no flexibility among the prices of the services constituting the supposed "basket." Therefore, either price caps should allow pricing trade-offs at the currently defined "basket" level, or new "baskets" (perhaps the current "subclasses") should be defined and justified.

There is a useful trade-off between baskets and bands. Although as previously noted, bands do not prevent the *eventual* realization of any particular prices, they alter both the timing and the path to those prices. In these respects bands can serve a very useful ancillary role in moderating prices changes within baskets.

In the present case, if currently defined baskets meet the relevant criteria, I would urge strict pricing bands be employed to alleviate concern with the pace of price changes toward their eventual levels. A standard form for bands is to limit annual

price change on any specific service to plus-or-minus 5 (or sometimes 10) percent relative to the cap. Thus, if the overall cap is at 103 for the year, service price can be in the range between 98 and 108.

Question 9

Whether explicit or implicit, every price capped firm has some recourse in case of extraordinary adverse circumstances. Every such firm knows full well that the regulator ultimately will not let it go bankrupt or pay its workers or its outside suppliers. For this reason, as I have previously indicated, there is always some compromise with "pure" price caps. On the other hand, if such eventualities prove to be common rather than extraordinary, ad hoc pleading with the regulator would have replaced price caps as management's guiding beacon. For these reasons, such recourse should not be requested often and should be granted even less often.

The circumstances that in principle might justify an "exigency case" would be unforseeable and uncontrollable events affecting underlying cost parameters. For example, if the price of a particularly important factor of production for some reason skyrockets, then an appeal to the Commission might be in order. But ordinary variations and controllable events (labor costs, etc.) should not trigger such a pleading, since those are precisely the events that the Service is supposed to take control of. The criteria that I have outlined would limit grants to exigency cases with substantive merit and hence no sanctions would be appropriate.

Question 9(a)

I would distinguish the above exigency circumstance from exogenous changes in financial obligations due to administrative actions such as tax law changes or changes in accounting rules. These latter can be incorporated directly in the formula in a manner that passes such cost changes through to final service prices. The rationale for this pass-through is that exogenous changes by definition are outside the control of the company and therefore not subject to its efforts at cost control. The rationale for incorporating these into the price cap formula is that resolving these automatically eliminates the need for and risks of administrative intervention.

For these reasons, I would urge incorporation in the formula of those cost changes that are administratively determined. This would leave "exigency cases" for other, truly extraordinary events.

Question 9(b)

As I just indicated, exogenous cost changes are not controllable by the price capped enterprise. Thus for example, if half of total costs are exogenous and those rise or fall by 10 percent, the price cap should automatically change by 5 percent. Only if it does so will the cap remain equally binding on the firm.

The most straightforward mechanism for dealing with these

exogenous costs is discussed in the FCC's price cap plans for AT&T and the local exchange carriers. There, so-called "Y" factors are defined and enbedded in the formula so as to avoid the need for regulatory intervention in these cases.

Question 10

Any regulatory pricing system is subject to some efforts by the affected companies to "game" the system to their advantage. But each such plan is unique, as are the subject companies. For these reasons it is impossible to generalize experiences to produce a list of likely practices that would dilute the benefits of price caps.

The most that can be said with conviction is that every effort should be made initially to develop a price cap plan with the greatest of care, since any flaws or ambiguities will inevitably be exploited thereafter. The subsequent task of the Commission will be immeasurably eased by careful design of the plan and foresight into the behavior it will induce.

Question 11

I am not sufficiently familiar with the universal service aspects of the postal monopoly to answer this question with confidence.

Question 12

I am not sufficiently familiar with the universal service aspects of the postal monopoly to answer this question with confidence.

Question 13

I am not sufficiently familiar with the universal service aspects of the postal monopoly to answer this question with confidence.

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June 30, 1997

John M. McHugh
Chairman
Subcommittee on the Postal Service
Congress of the United States
House of Representatives
Rayburn House Office Building
Washington, DC 20515

Dear Chairman McHugh:

Enclosed are responses to the questions for the record following the April 16th hearing. Since many of my colleagues here at the National Regulatory Research Institute have worked on the implementation of price caps for regulated utilities, I asked several of them to assist in responding to the questions. As a result, these responses represent a group effort. Working with me on these questions were Kenneth Costello, Raymond Lawton, Vivian Davis, and Nancy Zearfoss.

As you are aware, state and federal utility commissions have had extensive experience in price cap regulation of telecommunications providers. Some evidence exists, along with a good amount of analytical effort, that allows us to present some helpful answers to the questions posed by the Subcommittee. With the caveat that each industry -- postal service, telecommunications, electric, rail, and water -- where price caps have been proposed have unique characteristics that require various modifications of the "pure' price caps model. There are, however, important and relevant insights that can be drawn from these industries, particularly the telecommunications price cap experience.

If you have any questions or if we can be of further assistance, please call or write.

Sincerely,

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RESPONSES TO QUESTIONS FOR THE RECORD FOLLOWING THE HEARING ON APRIL 16, 1997 REGARDING H.R. 22

by

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1. **Some witnesses have testified that the price cap index of GDPPI as proposed in H.R. 22 does not take into account the actual input costs of the Postal Service; i.e. labor costs comprising 80 percent of operating costs. For example, Professor Baumol stated that GDPPI is more appropriate for the capital intensive industries where price caps have been applied elsewhere, such as telecommunications, and he argued for consideration of an index that reflects the Postal Service's substantial handicraft components. Further, Dr. Christensen proposed that the Subcommittee consider a blended index of the Employment Cost Index (ECI) and GDPPI, to better reflect the Service's great reliance on labor. However, other witnesses, such as Mr. Sidak, suggest that basing an index on the Postal Service's capital-labor ratio represents flawed reasoning because the current cost mix is neither profit-maximizing nor cost-minimizing. What are your thoughts regarding selection of an appropriate index, and whether a blended index of ECI and GDPPI is appropriate?**

   a. **Although the bill proposes that the index be set in statute, how important is it that the regulator have discretion to revisit and adjust the index? What would be an acceptable time frame for the regulator to analyze the market, economic, etc., trends underlying the assumptions used in setting the index?**

Response:

A price index, ideally, should have four qualities: (1) it should be relatively stable over time, (2) it should *not* be closely correlated with the actual cost changes for an *individual* regulated entity, (3) it should be easily measurable or publically available, and (4) it should reflect, as closely as possible, the average cost changes for the industry within which a regulated entity operates. A preferred price index would be similar to the one accepted by the Interstate Commerce Commission for railroads, that is, an industry input price index. The railroad price-cap index adjusts the input price index by an industry-specific total factor productivity (TFP) index. Simulating competitive conditions, this index allows prices to change by the change in

the industry's average cost. Therefore, to the extent that an individual firm keeps its costs below this level, it achieves higher profits. This is analogous to the case where an unregulated firm's prices are driven by the industry's average cost, with profits to an individual firm dependent upon its ability to keep its costs below the industry average.

In practice, most price cap plans use an economy-wide price index. This is true for the U.S. telecommunications industry and the U.K. privatized public utility industries. Done partly for expediency, this use of an economy-wide price index presumes that the growth rate for the industry's input price index corresponds closely to that for the economy as a whole.

The Gross Domestic Product Price Index (GDPPI) has two major deficiencies for the Postal Service. First, the GDPPI may not represent a good measure of aggregate (or economy-wide) inflation. For example, by representing only about one-third of the economy covering sales for final consumption, the GDPPI inadequately measures this economy-wide output or input prices. Second, as criticized by Dr. Christensen, the index provides a poor proxy for input price changes at the Postal Service.

Notwithstanding these problems with the GDPPI, applying a blended index, as proposed by Dr. Christensen, seems somewhat ad hoc. Data limitations, partly because the Postal Service has monopoly power for some mail services, precludes the measurement of an "industry" input price index or TFP measure. So it logically seems that some sort of economy-wide price index as well as TFP measure must be used. Instead of a blended price index, one can use the GDPPI and adjust the X-factor for any discrepancy that is judged to exist between the Postal Service input price index and that for the economy as a whole.

There is precedent for this methodology in the application of price caps for Local Exchange Carriers (LECs). In this example, the Federal Communications Commission (FCC) adjusted the X-factor for the fact that LECs historically encountered lower input price changes than the economy as a whole. If, for example, input price changes are expected to be higher for the Postal Service than for the economy as a whole, then the X-factor could be adjusted downward from an otherwise baseline level to account for this.

Although having no great concern over the Christensen blended price index proposal, I believe that the index may complicate matters by combining two indices in deriving an input

price index in addition to including in the price cap formula a productivity index. In addition, I suspect, one objective of the price cap idea is to reduce the labor intensity within the Postal Service. If so, then one could argue, as Mr. Sidak, that an ideal input price index would incorporate a lower labor mix than what currently exists for the Postal Service. The Christensen proposed index would not do this.

The uncertainty at this time over what is the most appropriate price index argues for *not* explicitly specifying the price index in statute. This issue as well as others will probably have to be revisited over time as problems arise and lessons are learned. One should look at price caps as inevitably evolving over time in response to its previous performance. Certainly, this has been the case in the applications of price caps for the U.S. telecommunications industry and the U.K. public utility industries.

2. H.R. 22 bases the choice of the adjustment, or "X", factor on various measurable considerations such as costs, revenue, productivity, service quality, and demand. However, other witnesses suggest that the adjustment factor be a pure productivity offset. Yet others argue that the current subjective ratemaking criteria in the statute (e.g., fairness and equity, or the educational, cultural, scientific, and information value of the mail) be retained as the adjustment factor criteria. What are your thoughts regarding the establishment of the adjustment factor solely as a productivity offset? If other factors should be considered, which ones?

Response:

The X-factor can be used to represent residual factors that take into account other considerations besides productivity. These other considerations could include the financial condition of the Postal Service. The Postal Rate Commission should have the flexibility to adjust the X-factor for a following multi-year period for unexpected financial outcomes. If, for example, the Postal Service encountered financial difficulties in past periods, the Commission may want to adjust downward the X-factor for a subsequent period. Rather than applying a different input price index or making some other significant change, it seems that when the actual (e.g., financial) performance is unforeseen, varying the X-factor would be most feasible. This approach is more in line with how the X-factor is defined in the U.K. than in the U.S. where price caps are applied.

a. **H.R. 22 permits a positive or negative adjustment factor, as determined by the Postal Rate Commission after a full and open case. However, some have suggested that a positive adjustment factor should be permitted only under certain conditions and that these conditions should be specifically enumerated under the bill. These witnesses have stated that allowing for a positive adjustment factor would negate any cost savings and would send the wrong message to postal managers. What are your thoughts in this regard?**

Response:

A positive adjustment factor would be unusual, but not unprecedented. It has been used as a side condition to adjust prices for certain services, especially those that were previously subsidized or transacted in monopoly markets. The Postal Rate Commission, for example, may conclude that rate rebalancing should take place because of certain services being heavily subsidized in the past. In this case, a positive adjustment factor that pertains to previously subsidized services may be appropriate. This is probably the only reason to incorporate a positive adjustment factor into a price cap mechanism.

b. **Some testimony has recommended that a single adjustment factor be set by the Postal Rate Commission and that this would be the same adjustment factor for each basket. These witnesses have observed that setting individual adjustment factors for each basket places the Commission closer to cost-of-service regulatory decisions. However, others suggest that separate adjustment factors for each basket are necessary to take into account the fairness and equity considerations, among others, that many mailers in the noncompetitive category feel are important among baskets. What are your thoughts in this regard? How best can price changes among baskets be seen as fair and equitable? Would the use of price adjustment floors and ceilings be compatible with — or should they replace — the separate adjustment factors for each basket?**

Response:

A single adjustment factor should be used across the designated baskets. This is generally the way it is done in real world price-cap applications. Trying to determine a specific adjustment factor for each basket would drive up the cost of implementation as well as have no theoretical merit. As pointed out above, however, a different adjustment factor may be

appropriate under extreme or special circumstances, for example, where the policy objective is to have rate rebalancing to gradually phase out past cross-subsidies.

c. **Dr. Christensen suggests completely hardwiring the price cap formula by not only setting the index in statute, but also selecting the non-farm total factor productivity index published by the government as an annual adjustment factor. What other price cap regimes are completely hardwired, especially in statute? What are the pros and cons of such a suggestions; (for example, Dr. Christensen cites advantages such as the objectivity of the offset and the avoidance of any regulatory meddling)?**

Response:

Two general approaches for defining the adjustment factor prevail. One is the Christensen ("hardwire") approach; the other is the U.K. approach, which measures the adjustment factor on the basis of different determinants. Under the former, the adjustment factor is closely linked to total factor productivity. Theoretically, if an economy-wide price index (e.g., GDPPI) is used, the productivity offset should represent the difference between the productivity of the relevant sector and the economy as a whole.

The U.K. approach, in contrast, provides no direct linkage between productivity and the adjustment factor. Instead, it relies on a host of factors to arrive at the adjustment factor.

Experiences with price cap plans reflect that the adjustment factor will almost always be susceptible to political pressures. In the U.K., for example, the adjustment factor has risen over time to redress the problem of consumers receiving too little of the significant efficiency gains in newly privatized public utilities that were realized during the early years. In practice, the adjustment factor has been determined on the basis of both economic and political considerations.

In the U.S., productivity has played a more major role in determining the adjustment factor under price cap plans. But even here it has not assumed the sole determinant. For example, the Federal Communications Commission has added to AT&T's productivity a "consumer dividend" component to ensure that a sufficient portion of efficiency benefits would accrue to consumers.

Determination of the adjustment factors should probably be viewed more as an art than a science. A strictly mechanical approach, as proposed by Dr. Christensen, to determining the adjustment factor ignores the economic and political tradeoffs that are inherent in any price cap plan. While it is a worthy goal to take the politics out of ratemaking, experiences across different industries in different countries show that it is extremely difficult to do. If, for example, a firm under price caps earned extremely high profits for the last several years, at the time of the next rate revision it is inevitable that the adjustment factor for the subsequent period would be raised. While it can be argued that this is undesirable in terms of diminishing the incentives of a firm to make efficiency gains, such an action may reflect good economics and public policy. Historical productivity for either an individual sector or the economy at large may distort the expected productivity gains for a firm subject to a more flexible, efficiency-conscious regulatory regime. This would especially be true for a firm or industry that has significant inefficiencies.

The incorrect choice of an adjustment factor introduces a systematic bias in a price cap plan. In addition to producing persistent profits or losses to a firm, this bias causes prices to deviate further from costs over time, i.e., pricing inefficiencies. When addressing this problem, regulators must have some mechanism to correct for it. One way to achieve this would be to manipulate the adjustment factor in a way that mitigates against a recurrence in the future. In this way "regulatory meddling" can often be a good thing. "Hardwiring" the price cap formula and using an economy-wide productivity measure, as proposed by Dr. Christensen, would severely tie the hands of the Postal Rate Commission in taking the necessary action. Since the Commission is in a better position to adjust to future changing conditions, hardwiring the formula in statute is not recommended.

d. What considerations should apply in determining the makeup and number of product baskets? In other words, what are the principles that determine the number and content of baskets?

Response:

Economic theory would tend to support the setting of price caps across broad-based baskets. In the extreme case of a single basket, economic analysis shows that under certain

assumptions prices would tend to converge to second-best or Ramsey prices --- i.e., prices that minimize the loss of consumer surplus while permitting a firm to earn normal profits.

At the other extreme, separately capping each service at the individual consumer level would be administratively complicated and restrictive in terms of pricing flexibility. On the plus side, however, it would guard against cross-subsidization and "unreasonable" price discrimination, which would be more likely under broad-based baskets.

As a matter of principle, each basket should contain services that are reasonably similar in terms of the market conditions under which they are transacted. Combining into one basket services varying widely in the degree of competition faced by the Postal Service would tend to result in the price of some services to rise much higher than other services in the same basket. Although this may not be necessarily bad, constructing broad baskets would probably require some side conditions to limit price increases for those services where consumers have few choices.

3. The Subcommittee has heard various points of view on the issue of applying antitrust laws to the Postal Service; what do you see as some of the advantages and disadvantages in applying antitrust statutes to the Postal Service, particularly considering its position as a government entity? To what extent should competitive products of the Postal Service be subject to other laws as applicable to similar products of private companies, such as business practices rules (e.g., Lanham Act), customs laws, etc.?

Response:

The application of antitrust laws to the Postal Service is outside our expertise, therefore, we have no response to this question.

4. There is a great deal of concern, under the present system, regarding possible cross-subsidization. How does price cap regulation address this particular concern?

a. Do you feel it is valid to say that under the existing cost-of-service type of ratemaking, the Postal Service is more likely to overprice its monopoly products and services to subsidize its competitive items?

Response:

Under cost-of-service (COS) regulation, a firm would have an inherent incentive to cross-subsidize competitive services with revenues from monopoly services. In other words, the firm would be motivated to shift its costs to markets where it has more market or monopoly power. By itself, having the incentive to shift costs or cross-subsidize, does not necessarily mean it will happen. If the Postal Rate Commission had adequate information, it could detect cross-subsidies. Also, if postal rates are divorced from costs, then cost-shifting would be less likely to increase postal rates for monopoly services. But because regulators often do not possess adequate information and rates are based on reported costs, COS regulation is prone to cross-subsidization.

In contrast, one of the advantages of price caps over COS regulation is that the regulated firm would generally find it futile to benefit from cost-shifting or cross-subsidization. It eventually does this by breaking the linkage between a firm's prices and its reported costs.

b. How true is it that cross-subsidies generally reduce a firm's profitability in the long-term?

Response:

Cross-subsidies, to the extent they drive out competitors, can actually improve a firm's profitability in the long-term. But this assumes what is called predatory pricing, which many economists discount because of its irrationality under most circumstances.

Cross-subsidies, on the other hand, can hurt a firm's financial position if lost revenues from subsidized services are not offset by additional revenues from other services. An example of this occurs when a firm sells all of its services or products in competitive markets. Under this condition, the firm would be unable to locate a source of funding for its cross-subsidies. By increasing prices for any service or product to pay for cross-subsidies, the firm would price itself out of the market.

For a regulated entity, such as the Postal Service or a public utility, which operates in a mixed-market environment, it can usually find a source of funding for cross-subsidies. This is especially true if the firm holds a statutory monopoly for any of its services and sets rates on the basis of cost-of-service principles.

c. **What are the best ways to insure against cross-subsidization of competitive products from captive customers? In addition to the price cap itself, the requirement that competitive products cover costs and contribute a reasonable amount to overhead, and antitrust action, H.R. 22 authorizes the Postal Rate Commission to require that up to 50 percent of all profits in any given year be applied to limit or reduce prices for non-competitive products when the Commission's annual audit finds that non-competitive prices exceeded the cap, or that competitive ones were not covering costs or contributing reasonably to overhead. Are these disincentives enough; what should be the sanctions if the Commission finds evidence that the Service is cross-subsidizing?**

Response:

The best ways to prevent cross-subsidization include liberalizing markets to stimulate competition and, if regulation is still required, to place a "Chinese Wall" between competitive and monopoly services. Expanding the scope and intensity of competition in markets for the different services would make prices more transparent to consumers. Consequently, efforts to fund cross-subsidies through higher prices to certain services would become less successful.

The "Chinese Wall" would protect capture customers by divorcing the price they are charged from the profits that a firm earns from other customers. Under COS regulation, the firm has the incentive and often the ability to "gouge" captive customers by mis-allocating costs (i.e., cost-shifting) in the form of assigning accounting costs from its competitive services to its monopoly services. As discussed earlier, price caps can avoid this problem by severing prices from the firm's cost of service.

Erecting a "Chinese Wall" also means that competitive markets should be pretty much left alone by regulators. The only legitimate concern for regulators or any governmental actors would be when the competitive services are priced below incremental costs. As long as these prices generate sufficient revenues to cover the services' incremental costs, most economists would agree that no cross-subsidies exist. In other words, such a product would be "subsidy-free".

In sum, by establishing a rule that prohibits the Postal Service from pricing any services below incremental cost and, in addition, setting well-structured price caps for captive customers, no additional action seems to be required.

d. To what extent should Congress limit price discrimination in a commercial activity like postal service where Congress has limited competitive alternatives for buyers through the statutory monopoly? At what point is price discrimination "unfair" or "unreasonable" in a restricted market?

Response:

Price discrimination against certain consumers becomes more likely when consumers have less market choices. The problem of unconstrained price discrimination is a real possibility anytime a firm has a guaranteed monopoly in one market segment and faces competition in other market segments. Because the Postal Service has a statutory monopoly for some of its services, regulation needs to protect these consumers from "unfair" or "unreasonable" price discrimination. In the case of public utilities, state and federal regulators have always permitted a certain degree of price discrimination. While many state statutes disallow "undue" or "unjust" price discrimination, regulators have had considerable leeway in interpreting what is undue or unjust. Generally, public utilities have the ability to price discriminate so long as rates cover incremental cost and no social standard of fairness is severely violated. The courts have generally not overruled the regulators in setting such discriminatory rates.

Many economists would argue that price discrimination is only unfair or unreasonable when prices for any service or product falls below incremental cost. The argument is that by charging below cost for a service or product, the prices of other services or products would have to increase in order to avoid financial losses by the regulated firm. In other words, consumers of these other services would be better off when the firm discontinues providing the subsidized service.

Under price caps, price discrimination may actually increase as the firm has greater flexibility to vary prices in response to market conditions. The degree of price discrimination depends importantly on the number of service baskets and what services are included in each

basket. As in the case of cost-of-service regulation, unfair or unreasonable price discrimination occurs when the price for any service lies below incremental cost.

e. **Currently, H.R. 22 requires each product in the competitive category of mail to cover its attributable costs plus make a reasonable contribution to overhead. To what extent should Congress require the Postal Service to recover a share of overhead ("institutional costs") and cost of capital from its competitive products collectively? Theoretically, the Postal Service and potentially mailers will benefit if the Postal Service earns one dollar in marginal revenues from competitive markets, i.e., without recovery of any overhead. Likewise, it may be that markets will be distorted and private companies disadvantaged if the Postal Service can compete without the discipline of recovering a fair share of overhead in competitive markets. How should Congress strike a balance between these positions?**

Response:

As pointed out earlier, the economically defensible price floor for a service is incremental cost. Economists generally agree that price floors above incremental costs (to cover overhead for example) can produce inefficiencies and runs counter to the operation of a competitive market. Firms, for example, denied the opportunity to set prices below embedded costs (e.g., incremental costs plus institutional costs) stand to suffer financial losses when their competitors are able to price down to their incremental costs.

By allowing a firm to price at incremental cost or above, any switching of suppliers by customers could be regarded as economically efficient because the regulated entity would lose customers only to those suppliers that have lower economic costs. The regulated entity has the ability to retain customers whenever it can supply a service at a lower price than its competitors.

In sum, placing a price floor above incremental costs would give an unfair advantage to private companies. Some of these companies may be able to compete successfully with the Postal Service only because of the protection they enjoy when the Postal Service is constrained from pricing competitive services in line with prevailing market conditions.

f. **If Congress requires the Postal Service to recover a share of overhead ("institutional costs") and cost of capital from its competitive products**

collectively and otherwise comply with the same laws as private competitors, is it reasonable to hope that over time the Postal Service's participation in competitive markets will create an incentive to increase it efficiency in non-competitive markets to the same standards as private industry? Or will the price cap mechanism --- on its own --- help increase the Service's efficiency in non-competitive markets without expecting these changes to come from additional requirement on competitive products?

Response:

The price cap mechanism should be seen as the primary vehicle for improving the Postal Service's efficiency in non-competitive markets. It is convoluted to argue that imposing a higher price floor on competitive services would elicit better performance by the Postal Service in non-competitive markets.

A price cap mechanism that establishes separate baskets for competitive and non-competitive services would have two outstanding outcomes: (1) consumers of non-competitive services would be protected against cross-subsidization and "unreasonable" price discrimination, and (2) the Postal Service would have strong incentives to control its costs for all services to the extent it regards higher "profits" as a desirable goal. Imposing an artificial price floor for competitive services not only would distort the market for those services, as argued earlier, but it would also have minimal or no effect on the Postal Service's efficiency in non-competitive markets.

5. The Subcommittee has heard differing views on the need to incorporate oversight of the quality of service in a price cap framework H.R. 22 includes this review of service performance in the annual audit by the Postal Rate Commission. What are your thoughts on how, if at all, the Postal Service's achievement of its delivery service standards should be overseen in a price cap regime? Should the Commission also have a role in setting those service standards?

Response:

For all regulated utilities (electric, gas, water and telecommunications, whether under price caps or not), state public service commissions use customer complaint programs, reporting requirements and field investigations to monitor quality of service. Adequate monitoring and enforcement of service quality standards is especially important under price cap regimes because

of the tendency of the regulated firm to cut costs and provide inferior service to captive customers.

The primary means of monitoring is processing complaints. Usually commissions distinguish complaints from inquiries, though they keep track of both. Inquiries to the commissions can be resolved merely by working with the regulated company to give customers better information on their service and what they can expect. Complaints represent an actual failure by the company to provide acceptable quality of service. Commissions assign staff to the complaint processing function and track the numbers and types of inquiries and complaints they receive and handle.

The second type of monitoring used by commissions is reporting requirements. State commissions include service quality among the data that must be submitted in reports (usually annual) from regulated utilities. In telecommunications, the Federal Communications Commission has not set specific service quality standards but does have an electronic management information system for monitoring service quality for the nation's largest telephone companies, which are under federal price cap regimes. The companies report annually to the FCC. In establishing a monitoring system, decisions to be made include the timing, level of detail and format, as well as operational definitions of any particular standards to be met. Field investigations are the third form of monitoring that public service commissions use. While more costly than customer complaint programs or company reporting, field investigations often provide information not otherwise available on such matters as how quickly you can get dial tone or whether a pay phone is working.

Customer satisfaction surveys have often been solicited from the regulated companies as part of routine reporting requirements but may also be conducted directly by a commission. Left to conduct customer satisfaction surveys themselves, telephone companies have typically reported very high rates of customer satisfaction (in the range of 95 percent). An independent survey recently conducted by the NRRI found much lower levels. These results suggest that Commissions should have an active role in monitoring, rather than accepting company results. In general, commissions are also active in setting the standards that regulated companies must meet. Standard setting is ordinarily a formal commission proceeding that includes testimony by

commission staff and company and other parties, such as consumer groups. More informal, collaborative efforts such as work groups are also used to reach an understanding and consensus on standards.

The Postal Rate Commission should only punish for non-attainment of desired service quality levels and not reward "a second time" the Postal Service for achieving the desired levels. The second reward comes about because the existing price caps already provides a sufficient economic reward in the opportunity to earn profits. Adding an "incentive reward" on top of the existing economic reward would make prices be too high. If a firm is given a positive additional incentive by a regulator for achieving service quality goals, such as being allowed to increase prices, this introduces a distortion that may result in too much quality or in more quality than consumers would otherwise pay. Moreover, this possible doubling of the reward is only available to the regulator if the incumbent has market power and captive customers.

a. You indicate in your testimony that 16 States have price cap plans with a penalty for service degradation. Please expand on those penalties; for example, what kind they are and how they are applied.

Response:

All commissions can impose penalties for persistent quality of service deficiencies, whether they use a price caps means of regulation or not. Fines or reparations, show cause orders, revocation of the license to operate, a citation for contempt and prosecution by the state attorney general are possible penalties. Fines and reparations are probably the most common penalty. They are more effective if targeted to individual customers (as rebates, for example) rather than as general rate decreases spread over many customers. The experience of the state commissions has tended to be that financial penalties are often minimal by the time they are negotiated and actually applied.

Penalties in state telecommunications price cap regimes are sometimes included in the price cap formula, but more often are separate conditions. Some examples of treatment of service quality under price caps (the appendix provides more detail on five states):

- **Illinois:** The price cap formula for Ameritech-Illinois includes a reduction of .25 percent from the inflation index for each of eight different service quality criteria, or a total possible penalty of a reduction of 2 percent in the allowed price increase (see appendix).
- **Ohio:** Like Illinois, includes service quality penalties as part of the price cap formula.
- **Rhode Island:** A service quality index has monthly measurements and the rating of 41 quality of service indicators. If the service quality index falls below prescribed levels in any month, the effective date of any proposed price changes is delayed.
- **Texas:** As a condition of price cap regulation, companies must meet recently revised q lity of service standards.
- N **York:** Nynex's price cap plan approved by the New York Public Service Commission in 1995, includes extensive service quality requirements.
- **Colorado:** Rate increases under the price cap plan can be disallowed by the commission if a telephone company fails to meet service quality standards (see appendix).
- **New Jersey:** The Board of Public Utilities may terminate the price regulation plan if "substantial degradation of service is found to exist."

6. H.R. 22 permits the Postal Service to experiment with new products and services. How important is this testing authority to an incentive-based regulatory system, and how much freedom should the Postal Service enjoy in testing new products? How much oversight is necessary, particularly to guard against cross-subsidization? For example, what role should a regulator play in the introduction of new products or services by a regulated utility?

Response:

Federal and state telecommunications price cap plans intend (among other things) to encourage the development of innovative new services. In particular, some consensus has emerged that one way to encourage the introduction of new services is to minimize the amount of regulatory oversight. Utilities have successfully argued that they need to be able to deploy new services with two to four weeks notice to the regulatory commission and to be able to test market new services. Generally this means that utilities only have to give notice that they are testing a new service. The implicit presumption in this approach is that absent a strong showing by

commission staff or some interested party, that the regulatory commission will only "log-in" the new service and refrain from exercising oversight, until needed. The regulatory commission still retains its investigatory and corrective powers, but presumes that, absent a complaint, no further action is required. The main constraint is that the new service must be "different" from an existing service, and not merely be a scheme for avoiding regulation through mislabeling.

Ideally, a firm offering a new service would want to cover the product's incremental cost (and at least its average cost). It is unclear if during a test market phase that the new service must cover incremental cost. Accordingly, there is some concern that a test market phase should be limited in duration in order to prevent gaming. In order to ensure that a valid incremental cost study is submitted, commissions can pursue two options. One is to reach a detailed generic agreement on the incremental cost methods and data to be used before any new service is introduced. The regulatory commission would then only have to "check the math" when an incremental cost study is submitted as a part of the notification process. A second way is to accept the incremental cost study submitted and reserve the right to review the study and make any needed adjustments at a later time. Absent a complaint, this effectively means no review occurs. A third approach is to require advanced notice — essentially an intent to file notice — that allows commission staff lead time to efficiently organize a prompt review.

Regardless of which approach is chosen, commissions typically state that new services must cover their incremental cost. As there are many ways to calculate incremental cost— all of which seek to shed or move costs to the advantage of a particular service— agreement on the incremental cost method is essential. Many state commissions and the Federal Communications Commission favor a forward-looking method called Total Service Incremental Long-Run Cost (TSLRIC), or Total Element Long-Run Incremental Cost (TELRIC). Unfortunately there is much less agreement on how to actually calculate the costs. The Postal Rate Commission should institute a workshop or proceeding that results in an official detailed incremental cost method. This would allow short review periods and still allow adequate review so as to ensure that no cross-subsidization is occurring.

a. Who should determine the placement of new products into price cap baskets; the Postal Service or the Postal Rate Commission?

Response:

The Postal Rate Commission, with general guidance from Congress, should decide which services are assigned to which baskets. One danger is that if baskets contain heterogeneous services (that is, a mix of competitive and noncompetitive services), a powerful economic incentive will exist for firms to price noncompetitive services higher so that competitive services can be priced lower. This gives the incumbent monopolist a tremendous advantage over entrants that do not have "captive" customers that can be economically leveraged for anticompetitive purposes. This outcome would significantly undermine the pro-competition and efficiency, and innovation goals achievable under price caps. Only the Postal Rate Commission will be objective enough to ensure that appropriate services are assigned. State and federal regulatory commissions, albeit with different results, have devoted a lot of effort toward creating and maintaining "competitively homogeneous" baskets of telecommunications services. Over time, the Postal Rate Commission may change the placement of services as experience is gained with the new products and, when possible, competitive markets develop.

b. Should the Postal Service be allowed to provide non-postal services like financial services, electronic post marks, T-shirts , etc.? Why or why not? If so, under what conditions should they be provided? Can non-postal ventures help underwrite the costs of universal service?

Response:

No equivalent analog exists in telecommunications price caps regimes. It is likely that a separate subsidiary of the utility holding company would be employed. Some commissions have the ability to examine the affiliate transaction charges between unregulated affiliates and the regulated affiliate in order to prevent cross-subsidization. There is some anecdotal evidence with electric utilities that allowing them to get too far from their main mission leads to financial difficulty when a substantial investment turns sour. Obviously, relatively modest ventures such as T-shirts are unlikely to be much of a problem. The Postal Service should not be prevented, or

perhaps should even be encouraged to get involved in more promotional activities and trying to sell new services that stem from its expertise in related services.

7. Are there specific issues that the Subcommittee should consider when requiring the baseline rate case? Should the Postal Service continue to have sole authority to set its revenue requirements for this last omnibus rate case; are there any specific items that should be built into this particular revenue requirement?

Response:

An important consideration for state and federal commissions is that if the old system is less efficient than price caps, then it would be counter-productive to carry forward the cost inefficiencies embedded in the old regime. One frequent correction lately has involved recognizing the current lower cost of capital, compared to the higher capital costs embedded in previous rates. Other considerations included the lower unit cost of new technologies, lower labor rates due to early retirement programs, the lower per unit costs associated with increasing call volume, lower costs associated with modern purchasing practices, and lower regulatory compliance costs.

All revenue requirement analyses used to set the original price cap price were set by the involved state or federal regulatory commission. Some did not initiate new rate cases as they felt they already had the results of a recent vintage rate case available. Most initiated a full-scale rate case. The Postal Rate Commission should explicitly retain sole authority over the revenue requirement.

a. What have been some of the more common parameters utilized in other price cap regimes to insure that the new system is established correctly and "gets off on the right foot?"

Response:

Most common parameters are identified above in "specific issues." Generally the telecommunications utilities agreed to include some premium services into the basic service definition. Touch-tone dialing is one example of a previously premium service (priced at one-to-three dollars a month, but having a much smaller incremental cost) that utilities agreed to include

into the existing flat-rate monthly charge. Other items included wiring schools, hospitals, and other public facilities for information age access, innovative pilot demonstration projects, and improved access for disabled citizens. A common feature in the 38 price cap states is the use of a freeze on basic rates for a three-to-five year period. Some freezes applied to residential and business basic rates (33 states), while others (five states) applied only to residential. The intent here is to provide protection against price increases in periods when costs are otherwise expected to decline.

Eighteen states required that the utilities file infrastructure development plans. This was important in these states to provide assurance that modern infrastructure would be deployed. In the other states the decision was to let the efficiency-increasing incentives in price caps guide modernization. It would be fair to conclude that most analysts felt little concern about the modernization of "profitable" areas. However, infrastructure plans were thought to be needed in the rural and less economically attractive areas.

Nearly every price cap plan contains a statement that service quality levels are not to decline under price caps. As noted, sixteen states have price cap plans that contain specific penalty mechanisms. Absent a specific penalty mechanism, a state would have to rely on its residual ability to levy fines and order corrective actions. A worry here is that a small or symbolic fine could be considered a normal cost of doing business and be disregarded.

Perhaps even more important than the price cap is the price floor. Unless high inflation is assumed, or unless productivity increases will not exceed the national average, then the real issue is how to use pricing floors to prevent anticompetitive pricing practices. Consider this simple example. The incumbent keeps prices at or near the price ceiling until a competitor emerges, and then drops prices 30 percent. This deters or drives out the entrant, and the incumbent resets its prices at the ceiling. Regulatory commissions have not been uniform in their approach, but a generic approach that did the following appears to reflect mainstream concerns in telecommunications price caps cases.

- Set downward pricing limits of, say, ten percent a year.
- No storage of unused downward pricing flexibility is allowed.
- Establish a rule that all services must cover incremental costs.

The net result of these rules is that if the incumbent engages in ceiling pricing when an entrant is able to come in at a significantly lower price, the incumbent will be hurt by not being able to lower its prices enough. Knowing this, an economically rational incumbent responding to the price cap efficiency incentives will act to keep its prices closer to what it believes a new entrant would charge. Two benefits occur. First, consumers get lower prices. Second, entrants are not deterred by anticompetitive pricing practices

b. Recognizing that existing law requires the Postal Service to operate under a break-even mandate, the current rate setting process allows for additional revenue in the rate structure to cover contingencies as well as to recover prior years' losses. Should these additional revenue provisions be included for this final rate case? Why or why not?

Response:

An important efficiency incentive in price caps is the use of one year accounting periods. Utilities are not allowed to save up unused upward or downward pricing flexibility and use it in a subsequent year. As noted above, this forces a utility to give efficiency gains to consumers in the form of lower prices each year. Furthermore, being able to save-up means that captive customers are being taxed in the form of higher than needed postal rates. A private firm has "nothing to save-up" and must price and act efficiently if it is to survive and prosper. Allowing the incumbent the ability to tax captive customers when things are going poorly will weaken the price cap incentive structure.

8. How often should the Postal Service be allowed to increase prices that are subject to the rate cap? H.R. 22 proposes that the Service be permitted once-yearly price increases. Is this appropriate? Should the rate cap be cumulative in nature in that the Postal Service would be allowed to make up for lost increases if it decides to forgo a rate increase in one or more years, subject to the cumulative cap?

Response:

A price cap basket will include a mixture of established, market testing, and new services. Once-a-year price adjustment is the norm for telecommunications price caps, although it would be possible in a given year that a market-tested product could also evolve into being a new

service. As long as the incumbent has significant market power, more frequent price adjustments suggest that the incumbent is engaging in some form of discriminatory pricing. By limiting price adjustments to once-a-year, the incumbent is given a strong economic signal to have its prices track costs and to have its prices reflect competitors' prices. Failure to have prices track costs, or competitors' prices, means that the incumbent has to wait a "year" to catch up, and lose revenues and profits. It may be prudent to have a rule that says that the once-yearly restriction may be lifted upon a showing that a basket (and not an individual service) faces a competitive market with not less than five national providers and the largest provider's market share is less than 50 per cent.

As noted above, carrying over lost or unused upward or downward pricing flexibility is counter to the efficiency-increasing goal of price caps. Only an incumbent with market power and captive customers could use this type of strategy. In telecommunications price caps a "use it or loose it" annual approach is the norm.

Independently of the "lost increase" mechanism, a firm must prudently organize its existing financial structure to cover short-term losses and to ensure its ability to obtain capital from financial markets at favorable rates. A firm under telecommunications price caps must design such an optimal financial structure without regulatory guidance or "preapproval." Doing otherwise, because of the information that would be required for regulatory oversight, would cause price caps to devolve back into traditional rate-of-return regulation.

a. At what level of the rate schedule should the cap apply? H.R. 22 would apply the rate cap to the subclass level in each basket, thereby permitting the Postal Service the ability to average rate increases among rate categories within a subclass. Should such averaging be restricted through price bands? If so, how?

Response:

Pricing at the basket level is the norm for telecommunications price caps. However, it may be that the way baskets have been organized in telecommunications offers limited guidance. Generally three baskets have been used: basic or monopoly services, nonbasic or potentially competitive services, and nonessential and competitive services. If postal baskets have a more

complex structure-- say, reflecting necessary vertical or horizontal integration of services within a basket-- then subclass or subbasket pricing may be appropriate. The key, however, is making sure that noncompetitive services in a basket or subclass cannot be leveraged to "subsidize" more competitive services. Note here that cost-shifting may be the proper concept rather than cross-subsidization, as prices charged for the competitive service may still be above its incremental cost.

9. H.R. 22 would allow for an "exigency case" should the Postal Service find that it faces severe financial exigencies and a change in the adjustment factors is needed to restore the Service to fiscal soundness. If the Postal Service requests such a case, the Postal Rate Commission would then decide whether or not to change the adjustment factors that apply during the then current 5 year ratemaking cycle. What are your thoughts on this provision? Under what circumstances, if any, should an exigency case be allowed? What sanctions, if any, should be applied if the Postal Service would seek additional revenue under this procedure?

Response:

As noted in the original testimony (by Kenneth Rose) and discussed at the hearing, a price cap program should provide a symmetrical incentive to the firm. It is not only the pursuit of profit that induces cost efficiencies, but also the avoidance of losses. In that sense an exigency case would only detract from the price cap incentive and is not recommended. In addition, as also noted previously, it is not clear if the Postal Service will react to the positive incentive of possible higher profits since it is an independent government corporation. It was recommended that, at the very least, the bonus provision in H.R. 22 may need to be strengthened to get the desired efficiency effects. Since it is not clear whether the Postal Service will have sufficient incentive for earing a profit, an exigency case provision would only further diminish this already weak incentive. There are considerations, however, that may argue for a departure from the pure price cap ideal. An exigency case provision may be needed to keep the Postal Service financially strong enough to provide the services that are regarded by Congress as essential and that are unlikely to be provided by a competitive firm. The obvious example is first class mail service. It is highly unlikely that a competitive firm can provide the same kind of service for the same

uniform rate. This is a public policy goal, however, and is not derived from economic theory. It should be recognized that the trade-off to meet this policy goal is a loss in economic efficiency.

Since utilities that are subject to price cap regulation are for-profit firms, there is no direct experience to draw from. However, if it is decided to have price caps for the Postal Service and since there is some doubt as to how well a price cap mechanism will work with the Postal Service, Congress may consider a trial period, of three to five years for example, where price caps for the Postal Service are tested. The Postal Rate Commission could provide annual interim reviews to Congress on how the price cap program is working. After the trial period, the Commission or Congress could either continue or discontinue the program.

a. Instead of the exigency case approach, some witnesses have suggested that the statute specify that the rate cap only be adjusted for specific financial burdens placed on the Postal Service outside of its control, such as Congressional budgetary obligations. How should the rate cap formula deal with such emergencies? How specific should the statute be regarding the Commission's determinations of exigent costs?

Response:

The original formulation of telecommunications price caps did not have an adjustment for exigency. The Federal Communications Commission's price cap plan for AT&T included an "exogenous adjustment clause". Most state commissions have adopted the exogenous adjustment clause. The rationale for the exogenous adjustment is that price caps only deal with those normal factors susceptible to managerial efforts of the firm. A major tax law change or change in a commission-imposed requirement would be outside of the efficiency-increasing activities a utility's managers could be expected to make.

Because of the dangers of abusing an exogenous adjustment mechanism, commissions have developed rules. These include saying that

- The burden of proof lies with the petitioner
- Commission staff and the utility can petition for adjustments

- Adjustments can be upward or downward: hence, the need for commission staff to be able to petition for exogenous adjustments
- Adjustments can only be requested if some aggregate threshold, say, if the changes would exceed two percent of annual revenues
- The policy of the commission is not to protect the utility against every upward cost risk, because in nearly all cases these are the cost pressures faced by all telecommunications providers

A relatively limited number of exogenous adjustments have been approved. The argument against an exogenous adjustment is that such a mechanism is not available to the utilities' competitors and can only be used when the utility has market power and captive customers.

10. Are there particular practices that have been noticed in other industries using price caps that allow the regulated company over time to attempt to dilute the desired incentives and reduce the potential for cost reductions that the regulator, in turn, should be aware of and specifically monitor?

Response:

Of course, any regulatory mechanism can be manipulated by the regulated firms. Under cost-based regulation, for example, firms would routinely inflate the amount requested for the allowed rate-of-return. Similarly, the main form of possible manipulation is related to the design of the price cap mechanism or during the process of setting the caps in an effort to have the cap set as high as possible. For example, as would be expected, firms argue for the most favorable price index (i.e., the highest one) when the mechanism is initially being set up by a legislature or regulator. Once the design is determined, firms will argue for relatively low productivity offsets. Perhaps the biggest source of possible manipulation of the process is when the price cap mechanism allows consideration of exogenous factors. In this case, firms will try to justify as much of these costs as beyond its control as possible to be included in the calculation (this is

discussed in question 9a above, including rules to avoid this abuse).[1] An important consideration for the Postal Service, at least initially, is the lack of "consumer advocates" that are familiar with price-cap process and procedures. This may cause too much reliance on the analysis and requests from the Postal Service.

Other forms of manipulation of the process have be discussed elsewhere in this response. These includes, cross-subsidizing or shifting costs to the regulated services (see response to question 4). Also as discussed, when market baskets includes items that are competitive with others where customers have fewer choices, firms may charge at or near the cap for the non-competitive services (if above incremental cost) and use the proceeds to subsidize the competitive services below the cap. Another means is to simply allow the quality of service to decline to reduce costs (see response to question 5).

11. Assuming "honest, efficient, and economical management" (the statutory standard in Section 3621 of Title 39) of the Postal Service, how large of a statutory postal monopoly is needed to sustain the current level of universal postal service? How can this question be answered? Do we first need to define universal service? Why or why not? If so, how would you suggest that the nation define universal service in the postal service context?

Response:

The question of the size of the monopoly was not directly addressed in telecommunications price caps for two reasons. The first is that a national goal of affordable universal service existed. This meant that state and federal regulators would take prompt action should universal service be threatened. This understanding among all parties, while unwritten, largely took universal service questions "off the table" in price caps: price caps were expected to continue deployment of modern infrastructure and services, but in no case would degradation in universal service be allowed. The second is that the basic service or monopoly basket was so large (not less than 97 percent, variously measured) that its continued existence was assumed. And when large gains by challengers do occur, rules and laws exist sufficient to have all

[1]Profit-sharing mechanisms that are part of the price cap process are another source of potential abuse, but this is not being considered for the Postal Service.

telecommunications providers contribute into various universal service funds. State and federal commissions would have the authority to have a "carrier of last resort" or an eligible telecommunications carrier serve "unserved" customers and to pay for this coverage out of universal service funds.

The question of defining universal service is answered in more detail below. The central thought is that affordable service should be ubiquitously available upon demand. The area of less consensus is what should be on the universal service list. Should it be the minimum basic service or access to all services. In telecommunications the worry is that we could evolve into a nation of information "haves" and "have nots," with disastrous economic and social consequences. Generally the question has been answered favoring basic service, with access to all services being a secondary concern.

12. To what extent do "universal service" obligations set by Congress impose additional costs that the Postal Service would not normally and reasonably incur if operated as a private business? How can this question be answered?

Response:

There is no doubt that universal service obligations ordinarily impose costs on a company that would not be incurred if the company were left to its own devices. Measuring the costs is extremely difficult, especially if you try to assess "normal and reasonable" behavior. What is normal varies according to such factors as market power, available market niches, level and elasticity of demand, and innovations (especially cost-cutting innovations), not to mention the impact of regulation.

Part of the initial regulatory bargain embodied in the Communications Act of 1934 was the promise that AT&T would provide affordable service to everyone in the United States in return for assurance of monopoly status. Regulation of a monopoly (whether through traditional rate-base, rate of return regulation or price caps) is itself a means of promoting universal service, since otherwise the monopoly firm would normally restrict output and keep prices high. Since costs and ability and willingness to pay for telephone service vary by income, demographic group and geographic region, universal service policy has included widespread distribution of the cost

burden within the overall umbrella of regulation of monopoly prices. The result was the growth of a labyrinthine and hidden subsidy system that in general directed revenues from interstate to intrastate, urban to rural and business to residential to keep residential rates low, particularly in areas with relatively high costs. The costs imposed on regulated telephone companies from the universal service obligation, given the history of the policy's implementation and for lack of a better measure, might be considered equal to the total amount of the subsidies. Efforts at estimating the extent of the subsidization have produced widely different results, however, ranging from $1 billion to $20 billion. And there is a suspicion that some telephone companies are being subsidized at higher levels than are necessary for normal operation as a private business, so that some of the subsidies may be unnecessary and anti-competitive.

With the advent of competition in telecommunications and the prospect of needing to divide up the responsibility for funding universal service there is new concern for assessing the costs. Efforts are just now being made to replace the existing subsidy system with one that is simpler, more explicit and more transparent but also sufficient and pro-competitive. In doing so it has first been necessary to define exactly what the basic service is which is to be provided universally (dial tone, access to emergency services, etc.). The degree of universal service is (and has been) measured in "penetration rates" — the percentage of households which have a telephone. Penetration rates vary by income level and demographic factors. Measuring penetration rates provides a way of defining a benchmark level of universal service. If existing penetration rates for a well-defined package of basic telephone services are acceptable, the level of revenues currently being yielded is presumably acceptable as well. A price cap formula will maintain those revenues at an overall reasonable level.

Accurate measurement of costs would go far towards resolving the question of how subsidies should be distributed. Several models have recently been developed to estimate the costs of providing telephone service under a range of conditions, but it is proving very difficult to get agreement among the affected parties on which model to use. In its May 8th, 1997, order on universal service, the FCC decided to continue to seek a proxy cost model so that the level of support for service to a particular customer will ultimately be determined based upon the forward-looking economic cost of constructing and operating the network facilities and functions

used to provide that service. The Commission said, "Forward-looking economic cost best approximates the costs that would be incurred by an efficient carrier in the market [and] ....helps us to ensure that we are providing the minimum support necessary for the efficient provision of the supported services." (FCC Order 97-157, paragraph 199.)

To determine the amount of federal support, the FCC will subtract a revenue benchmark from the forward looking economic cost of providing the supported services (paragraph 200). The benchmark will be based on the nationwide average revenue per line, with separate calculations for business and residential services (paragraph 217). Thus there is a presumption that, at least on average, revenues reflect appropriate penetration rates. The FCC set Jan. 1, 1999, as the date when nonrural carriers will begin to receive support based on forward-looking economic costs, but postponed until further review the date when rural carriers begin to receive such support (paragraph 203).

The FCC set criteria for forward-looking economic cost determinations that may be of interest in planning or reviewing cost studies for postal services (paragraph 250):

1. The technology assumed in the cost study or model must be the least-cost, most efficient and reasonable technology for providing the supported services that is currently being deployed.

2. Any network function or element necessary to produce supported services must have an associated cost.

3. Only long-run, forward-looking economic cost may be included. The period used mus be long enough that all costs may be treated as variable and avoidable.

4. The rate of return must be either the authorized federal rate of return on interstate services, currently 11.25 percent, or the state's prescribed rate of return for intrastate services.

5. Economic lives and future net salvage percentages used in calculating depreciation expense must be within the range authorized by the FCC.

6. The cost study or model must estimate the cost of providing service for all businesses and households within a geographic region.

7. A reasonable allocation of joint and common costs must be assigned to the cost of supported services.

8. The cost study or model and all underlying data, formulae, computations and software must be available to all interested parties for review and comment.

9. The submission must include the capability to examine and modify critical assumptions and engineering principles (such as costs of capital and terrain factors).

10. Support calculations must be deaveraged, if feasible down to the census block group, census block or grid cell.

13. To what extent could the costs of the universal service obligation be financed by payments from a "universal service" trust fund, such as occurs with the universal service fund in telecommunications?

Response:

The effort to estimate costs of universal service in telephony is aimed at determining the appropriate level of funding for the federal Universal Service Fund. Other issues, given the emerging competitive market for telecommunications, include who should contribute in what proportions and how the fund should be administered. The FCC has decided, however, that only 25 percent of the estimated costs of providing universal service will be covered by the federal fund. The rest will be the responsibility of the states as a challenge to do their part to get rid of implicit subsidies. A trust fund can be a stable, dependable source of universal service funding for a large portion of universal service obligations. There is always a danger that if it appears "too" large it is susceptible to cuts. And trust funds on the federal level have been susceptible to use as an offset to the budget deficit rather than for the uses for which they were intended.

APPENDIX

Examples of Various Mechanisms States Have Used to Control for Quality of Service (Additional Information for Question 5a)

Alabama

On September 20, 1995, the commission adopted price cap regulation for South Central Bell Telephone Company. The formula for the price cap is GDPPI - 3%. This means that when the freeze on basic services ends, which will be the year 2000, the company will be allowed to raise the prices of basic local services by the amount of GDPPI less the productivity factor of 3%.

However, in order to provide the company with an incentive to maintain service quality, the commission also adopted four standards for service quality which could affect the price cap formula if not met. For each of these four standards which the company was unable to meet, the productivity or efficiency factor would be increased by .2%. So, if the company missed one of the four standards but met the other three, the formula to be used would be GDPPI - 3.2%.

In this way, the company is penalized in terms of the prices it can charge for basic services if it fails to meet the established service quality criteria. Since price changes can only be made annually, the company would experience the consequences from this penalty for a year.

Colorado

On May 26, 1992, the Colorado Commission adopted a price cap plan which also included the sharing of company earnings with ratepayers. Under this plan, if the company earned more than 13.5% return on its equity, it would share these earnings with ratepayers through lowered prices or rebates. If the company earned 16.5% or more return on its equity, all earnings in excess of 16.5% would be returned to the ratepayers.

In order to ensure continued high service quality, the company's performance on a number of service standards were to be measured. These measurements would then be used to determine the amount the company would be allowed to retain of earnings over 13.5%. The

service quality standards were comprised of 13 elements: 1 being from a customer satisfaction survey and carrying a weight of 10%; the other 12 standards listed are objective measures of maintenance (49.5%), provisioning (27.5%) and customer access (11%).

Using measurement thresholds developed by the company and commission staff, the company could earn a score for service quality between -100 and +100. This service quality score would affect the sharing of overearnings, with a higher score allowing the company to retain a larger share of earnings.

In addition, staff argued that individual measurement scores, not merely the net quality-of-service scores, were important and might be masked by aggregated scores. The commission accepted this argument and suggested that, should the aggregate score be 0, then the negative scores on the individual quality of service standards would be added to the 13.5% to obtain an adjusted ROE and all earnings between 13.5% ROE and the adjusted ROE would be returned to ratepayers. For example, if the Company scored -10% on one of the service quality standards (assuming no other negative scores), all earnings between 13.5 and 13.6 % ROE would be returned to customers.

While this plan was painstakingly constructed by the company, commission staff, consumer's counsel and such interveners as AT&T and MCI, a problem of enforcement occurred. The company was to be penalized for poor service quality by having a larger portion of its earnings over 13.5% returned to ratepayers than would have occurred if its service quality had been within the specified limits. But the company never had earnings over 13.5% and so, even though its service quality scores were -34.47 for 1993, -86 for 1994 and -68.52 for 1995, the company could not be penalized through the mechanism established. Instead, the commission has fined the company, US West, some $5.3 million since 1993.

Illinois

Illinois adopted a price cap plan, effective January 1, 1995. The formula for the cap was GDPPI - 4.3% productivity factor - service quality component. The service quality component was composed of 8 items: (1) percent installation within 5 days, (2) trouble reports per 100 access lines, (3) percent out of service over 24 hours, (4) percent dial tone speed within three

seconds, (5) operator average speed of answer -- toll and assistance, (6) operator average speed of answer -- information, (7) operator average speed of answer -- intercept, (8) trunk groups below objective.

Benchmarks were established for each of these 8 items. For each measure, the company receives a score of zero if it meets the benchmark, and a score of -.25 if it fails to meet the benchmark. Thus, if the company failed to meet all 8 benchmarks, the price regulation formula would be GDPPI - 4.3% productivity factor - 2.0% service quality component.

Maine

In the price cap plan adopted in 1995 and effective June 1, 1995, the commission adopted the following three service quality index categories:

(1) **Customer Service**, made up of (a) installation appointments not met, (b) held orders and (c) business office calls answered over 20 seconds;

(2) **Service Reliability**, made up of (a) customer trouble reports per 100 access lines, (b) trouble reports not cleared within 24 hours - residence, (c) trouble reports not cleared within 24 hours - business, (d) dial tone speed over 3 seconds, (e) service outages.

(3) **Customer Satisfaction**, made up of (a) service provisioning not meeting expectations -- residence, (b) service provisioning not meeting expectations -- business, (c) maintenance not meeting expectations -- residence, (d) maintenance not meeting expectations -- business.

The objective performance level for each category is set equal to the lowest annual average measured over a three year period. For each tenth of a percentage point that indices fall below this objective, customers would receive rebates of $75,000. Rebate amounts are capped at $1,000,000 per category per year and $10,000,000 total for all categories per year.

Massachusetts

A price cap plan was adopted in May of 1995, effective September 15, 1995. The price cap formula is GDPPI - (2% productivity factor + 0.1% input differential + up to 1% total for failure to achieve a certain level of service + up to 1% total for failure to achieve service quality objectives for 3 or more service categories in any month).

There are 12 Service Quality Categories, grouped under three headings, which make up the Service Quality Index:

Maintenance of Service composed of (1) network trouble reports per 100 lines, (2) percent of troubles cleared within 24 hours -- residence, (3) percent of troubles cleared within 24 hours -- business.

Installation Service composed of (4) percent appointments missed company reasons -- residence, (5) percent appointments missed company reasons -- business, (6) percent appointments missed -- company facilities, (7) installation troubles per 100 inward orders.

Service Response Items composed of (8) directory assistance -- average speed of answer, (9) customer service bureau -- average speed of answer, (10) toll and assist -- average speed of answer, (11) residence service level, (12) business service level.

Benchmarks were established for each of these 12 elements. The company could be penalized by 1/12 of 1% for failure to achieve a certain overall level of performance, as determined by Service Quality Index, in any one month period. The company could also be penalized 1/12 of 1% for failure to achieve the objectives established for any 3 or more of the 12 categories in any one month period. In this manner, the commission addressed both the overall level of service quality as well as the quality achieved in each specific category.

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August 29, 1997

The Honorable John M. McHugh
Chairman
Subcommittee on the Postal Service
Committee on Government Reform and Oversight
U.S. House of Representatives
B349C Rayburn House Office Building
Washington, D.C. 20515-6147

Dear Chairman McHugh:

This letter responds to your questions for the record following the April 16, 1997, hearing on H.R. 22, the Postal Reform Act of 1997. As in the case of my prepared testimony and oral testimony at that hearing, my answers to your questions are provided in my individual capacity and not on behalf of the American Enterprise Institute, the Yale School of Management, or any interested company.

My answers to a number of the Subcommittee's questions for the record are already contained in passages of J. Gregory Sidak & Daniel F. Spulber, *Protecting Competition from the Postal Monopoly* (AEI Press 1996). For your convenience, I refer to the relevant chapter or page numbers.

In addition, I identify points of consensus or disagreement in the testimony of the economists who appeared before your Subcommittee in April or submitted written statements for the record. The page numbers cited refer to the original hard copies that those witnesses submitted to the Subcommittee in April.

Q1. ***Price Cap Index of GDPPI***

My written and oral testimony expressed the extent of my thoughts on this issue. As I explained at the hearing, I believe that it is premature to discuss how price caps for the Postal Service might be structured, because the larger question is whether price caps can even work when applied to a not-for-profit enterprise.

The economic witnesses appearing before the Subcommittee in April agreed that price caps would not work as well for a not-for-profit organization like the Postal Service as they would for a privately owned, for-profit regulated firm. Professor William J. Baumol noted in his written submission that price caps would work "rather imperfectly" for the Postal Service, although he believed that "it is possible in principle" to design such price caps. (page 2) Professor Baumol suggested that "surplus" of the Postal Service be paid out in five ways, including incentive payments to nonmanagerial employees.

Likewise, Professor John Panzar considered it "unlikely" that incentive regulation would cause the Postal Service to act like a for-profit enterprise. (page 1) Professor Panzar stated his belief that the Postal Service's motivation is not profit-maximization, but "to support postal rates which maximize the

Postal Service's ability to obtain (and retain) mail volumes for which it is the least cost provider." (Professor Panzar did not explain how one would know that the Postal Service is the least-cost provider for services protected by statutory monopolies.) He thought that price-cap regulation can be designed to "further this objective." (page 1)

Other witnesses, including Professors Michael Crew and Paul Kleindorfer, expressed greater skepticism of the "residual claimant" problem with imposing price caps on the Postal Service. (page 3-4) "Absent privatization or a schedule to privatize," they wrote, "the benefits to be expected from incentive regulation are likely to be reduced significantly." (page 4)

Dr. Kenneth Rose remarked upon the incentive problem with price caps and noted (as I did) that H.R. 22 does nothing to create a financial penalty for poor performance by management, including quality degradation (discussed below). (page 9) He believed that "extensive modifications may have to be made to the current reward structure to induce the desired behavior." (page 9) Professor John Kwoka also focused on the "residual claimant" problem and asked, "Who, if anyone, should bear the adverse financial consequences?" (page 15)

Q2. ***Adjustment Factor for Price Caps***

My written and oral testimony expressed the extent of my thoughts on this issue. Again, I believe that lengthy discussion of this issue runs the risk of missing the forest for the trees.

Professor Baumol argued that mail delivery contains a "substantial handicraft component" that necessitates an X factor, other than the CPI, which reflects slow or negligible productivity growth. (page 3) Dr. Joel Popkin similarly referred to price caps for the Postal Service as a "wage cap." (page 5) Professor Baumol's point about slow productivity growth is an application of his theory of the "cost disease." My problem with the application of that analysis here is that, if the Postal Service's monopoly privileges remain intact and one used the kind of X factor that Professor Baumol would advocate, it would seem that we would help to perpetuate a technology for delivery of messages that is excessively labor intensive and thus allegedly resistant to productivity growth. For example, the statutory monopolies retard the ability of consumers to shift to other delivery technologies that *do* have appreciable productivity growth. Also, how do we tell whether an activity is truly subject to Professor Baumol's cost disease and not merely subject to the political pressure of a labor union for which a "lack of productivity growth" is a smoke screen for higher pay and more jobs (or fewer layoffs)?

Similarly, Professor Laurits Christensen argued that the price cap index "should mimic price formation in competitive markets," but he does not address how the statutory monopolies of the Postal Service frustrate that objective. (page 3)

Q3. ***Application of Antitrust Laws to the Postal Service***

As I explained in my testimony and in chapter 7 of *Protecting Competition from the Postal Monopoly*, I favor subjecting all activities of the Postal Service to the antitrust laws. Congress should do so explicitly, although I believe that, as a matter of sovereign immunity, the Postal Service may already

be subject to the antitrust laws.

Q4. ***Cross-subsidization***

I discuss the problem of cross-subsidization by the Postal Service at length in chapter 6 of *Protecting Competition from the Postal Monopoly*.

Professor Panzar opposed the proposal in H.R. 22 to impose on the Postal Service a price floor equal to attributable cost plus a reasonable contribution to the recovery of common costs. (page 6) He would eliminate the "reasonable contribution" component. Consequently, he advocated a lower price floor for the Postal Service than that in H.R. 22. One implication of his reasoning is to undermine arguments that the Postal Service is a natural monopoly: "Any divergence between marginal costs and average incremental costs is likely to be small in practice." (page 7) In other words, one implication of Professor Panzar's call for a lower price floor is to undercut the argument for retaining statutory monopolies for the Postal Service on the grounds that it is a natural monopoly (since marginal cost would be significantly less than average incremental cost for a natural monopoly).

Professor Panzar also did not recognize that one purpose served by requiring that the price floor add some "reasonable contribution" to common costs on top of attributable costs is that it is so difficult to determine whether the Postal Service has misallocated attributable costs for competitive services to the common cost category. In the absence of a more effective regulatory mechanism to prevent cost misallocation, the "reasonable contribution" requirement could be seen as rough justice. The issue is not whether pricing below incremental cost is permissible; there is agreement that such pricing would be too low. Rather, the question is whether the costs that the Postal Service *reports as being incremental* are accurate or whether they are so distorted as to undercut efficient competitors and exploit captive customers. Professor Kwoka seemed to allude to this problem when he wrote: "There does not seem to be the same long tradition of regulatory accounting that at least partially constrained AT&T and made its pricing predictable, if not always efficient." (page 16)

Q5. ***Quality of Service Under Price Caps***

I do not believe that price caps would work for the Postal Service. If Congress imposed them anyway, product-quality regulation would be necessary. Dr. Rose similarly emphasized the need to monitor service quality under a price-cap regime to prevent the Postal Service from degrading its service. (page 8) So did Professors Crew and Kleindorfer. (page 7)

In contrast, Professor Christensen disputed that service degradation is a concern and argued that "if Standard mail customers desire reliable service rather than speed, the service measure for Standard mail must be based on reliability." (page 7) I do not understand Professor Christensen's reasoning. What is "reliable" mail if it is not speedy? Surely we are not worried about the prospect of some nonexistent form of speedy but "unreliable" mail service. (By analogy, the Internet delivers e-mail only on a best-efforts basis. Can this be what Professor Christensen is alluding to? The way to circumvent the problem on the Internet is to send important transmissions several times and to get confirmation of delivery from the recipient.) Also, note that quality is likely to be a problem only with respect to services covered by

the statutory monopolies. For competitive services, consumers will quickly punish the Postal Service for bad quality by turning to private carriers.

Q6. ***New Products and Services***

For reasons discussed at length in my testimony and in *Protecting Competition from the Postal Monopoly*, I dispute the proposition that the Postal Service, either as it is currently governed or as it would be governed under H.R. 22, should enter *any* new product market.

In discussing the residual claimant problem with price caps, Professors Crew and Kleindorfer observed: "[The] insulation from the discipline of bankruptcy also means that a public enterprise, unless strongly reined in by the government, can get into competitive ventures on favorable terms and therefore compete unfairly and inefficiently with privately-owned companies." (page 4)

Professor Baumol urged that the Postal Service be subject to no "impediments to the introduction of new services." (pages 4-5) He did not identify, however, what mission the Postal Service is pursuing by offering services that are already being competitively supplied by private firms. Professor Baumol did not qualify his point by saying that such freedom should be conditioned on the lifting of the Postal Service's monopolies and other statutory privileges. Professor Panzar, however, said that he "cannot comment on the appropriateness of the $100 million revenue limit" for market tests of experimental products. (page 7)

Q7. ***Baseline Rate Case***

As stated above, I do not believe that price caps would work for the Postal Service. Therefore, I do not have a position on this question.

Q8. ***Price Increases Under Rate Caps***

As stated above, I do not believe that price caps would work for the Postal Service. Therefore, I do not have a position on this question. I do, however, have the following comments on the testimony of various witnesses on this subject.

Professor Baumol advocated that the Postal Service, under price caps, have pricing flexibility such that its price reductions would take effect immediately, rather than after some process during which their reasonableness would be determined. (pages 3-4) This is analogous to the efforts to declare telecommunications carriers "nondominant" so that their tariffs are effective immediately. Typically, an essential piece of evidence that has been required before the Federal Communications Commission will determine a carrier to be nondominant is that it lacks market power—as suggested, for example, by its market share and other evidence. It is interesting that Professors Crew and Kleindorfer conceded that a typical postal administration would "continue to enjoy residual market power for some time." (page 2) If the Postal Service were allowed to retain its various statutory monopolies, that fact would be inconsistent with the experience in other regulated industries in which a company has been relieved of tariff obligations as a result of being declared nondominant.

Q9. ***Exigency Case***

As stated above, I do not believe that price caps would work for the Postal Service. Therefore, I do not have a position on this question.

Q10. ***Price Cap Experiences in Other Industries***

The most authoritative and exhaustive discussion of the experience with price caps in other markets is David E.M. Sappington & Dennis L. Weisman, *Designing Incentive Regulation for the Telecommunications Industry* (MIT Press & AEI Press 1996).

Q11. ***Scope of the Statutory Monopoly***

For the reasons stated in my testimony and in *Protecting Competition from the Postal Monopoly*, I do not believe that any statutory monopoly for the Postal Service is justifiable. The greatest single shortcoming of H.R. 22 is its failure to repeal the Private Express Statutes and the customer mailbox monopoly.

Professors Baumol and Panzar were silent on the question of repealing the statutory monopolies and privileges of the Postal Service. In their written testimony, Professors Crew and Kleindorfer plainly envisioned a continuation of the statutory monopoly even under privatization: "In view of its universal service obligations, the Postal Service should continue to have some monopoly protection." (page 5) At the same time, they envisioned that "a privatized Postal Service would of course be subject to the full force of the antitrust law just like any other company." (page 6) It is unclear whether that would mean that even the services subject to the statutory monopoly would be subject to antitrust oversight, as I advocated regardless of whether the Postal Service were privatized or commercialized.

Professor Christensen seemed to endorse the Postal Service's position that, since the Board of Governors directs the affairs of the Postal Service so as to serve the public interest, it is unnecessary to subject the Postal Service explicitly to the antitrust laws. "The current regulatory oversight exercised by the Postal Rate Commission and the authority of the new, independent Inspector General should suffice." (page 6) Professor Christensen opposed Department of Justice or Federal Trade Commission antitrust oversight of the Postal Service, in part because he believed that it would discourage "qualified individuals from accepting appointments to the Board." (page 7) I disagree with Professor Christensen. One could say the same thing about the applicability of the antitrust laws to Microsoft or General Motors.

Q12. ***Cost of Universal Service Obligations***

As I explained in response to your question at the hearing, universal service has been an issue in all regulated industries, and Congress rejected statutory monopolies in the Telecommunications Act of 1996 as a means to fund universal service. Competition and universal service are not mutually exclusive. The continuation of universal service does not logically require the continuation of statutory monopoly. The rationale for that conclusion is explained at length in chapter 4 of *Protecting Competition from the Postal Monopoly* and at pages 156-56 of that book.

J. GREGORY SIDAK

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Q13. ***Universal Service Trust Fund***

As I explained in my testimony, the Telecommunications Act of 1996 provides an example of alternative funding of universal service. This issue is also discussed at pages 154-56 of *Protecting Competition from the Postal Monopoly*.

Q14. ***Universal Service and Nonuniform Rates***

Any move from uniform pricing to pricing that more closely resembles that found in a competitive market would reduce the magnitude of the universal service deficit in need of financing through alternative means.

Q15. ***Cost and Benefits of Current Postal Regulation***

As I argue in *Protecting Competition from the Postal Monopoly* and as I explained in my testimony, the current system of postal regulation does not resemble traditional public utility regulation because the Postal Service has far greater power relative to its regulator than any investor-owned utility of which I am aware. I know of no other instance in which a supposedly regulated monopolist retains the power, as the Postal Service does, to define the scope of its own monopoly.

Q16. ***Dependence of Universal Service on Continuation of the Private Express Statutes***

I know of no economic evidence that supports the conclusion that universal service can be preserved only by continuing the Private Express Statutes. I consider that proposition untenable on its face. If the provision of universal service requires subsidization to cover its total costs, that fact in no way implies that the only means to accomplish that objective is for the federal government to perpetuate a monopoly through the Private Express Statutes. Indeed, to the extent that the Private Express Statutes are seen as performing that function, they represent a hidden tax that Congress should make explicit.

Q17. ***Mailbox Monopoly***

I do not believe that any monopoly is necessary to preserve universal service. I criticize the statutory monopoly over the customer's mailbox at length at pages 33-38 of *Protecting Competition from the Postal Monopoly*.

Dr. Popkin opposed removing the customer mailbox monopoly. He argued against nonuniformed employees having access to the mailbox for anything "but the most vital reasons and certainly not to deliver advertising." (page 5) The last part of his phrase is telling, as it coincides with the concern, evident in Professor Panzar's remarks, that the Postal Service seeks to maximize volume. As I noted in my live testimony, the problem of uniformed carriers is easily fixed: Congress could require private carriers to obtain a license, post a performance bond, and dress their employees in uniforms. The argument that universal service would be undermined as a result of competitive access to the mailbox is also a canard for the reasons discussed in my testimony and in *Protecting Competition from the Postal Monopoly*.

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Q18. ***Two-Dollar Definition of Letters***

I have not studied how this proposed definition would affect the Postal Service's revenues. I discuss the legal and economic effects of the current rules defining "extremely urgent letter" at pages 26-31 of *Protecting Competition from the Postal Monopoly*. I reiterate that I oppose the continuation of any statutory monopoly for the Postal Service.

Q19. ***Deregulation and H.R. 22***

Congress should not enact H.R. 22 in its current form. If Congress does not want to privatize the Postal Service, then it should undertake the commercialization option that I discussed in my testimony and in chapter 7 of *Protecting Competition from the Postal Monopoly*. If Congress does not want to commercialize the Postal Service, then it should subject the Postal Service to stricter regulation and force its exit from demonstrably competitive markets, as I argue in chapter 7 of *Protecting Competition from the Postal Monopoly*.

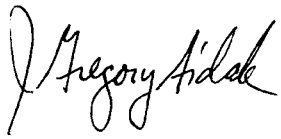
* * *

My understanding of the economic testimony presented at the April hearing is that a consensus emerged that H.R. 22's price-cap proposal would be seriously flawed unless the underlying ownership structure of the Postal Service were revamped. I commend the Subcommittee for probing the salient economic question of whether the incentive compensation provisions of H.R. 22 would suffice to solve the residual claimant problem. Unfortunately, the consensus answer of the economic witnesses was no.

Given that fundamental difficulty with H.R. 22, a more productive agenda for the Subcommittee would, in my view, entail (1) reforming the funding mechanism for universal service along the lines of what Congress has done in telecommunications; (2) repealing all of the Postal Service's monopolies and other statutory privileges; and (3) imposing explicit antitrust oversight of the Postal Service. In short, the Postal Service is not a natural monopoly, its statutory monopoly is unnecessary to finance universal service, and Congress's perpetuation of that monopoly protection in any new postal legislation would be an anachronism relative to what is happening in other communications industries.

Thank you again for the privilege of testifying before your Subcommittee.

Sincerely,



FOLLOWUP QUESTIONS AND RESPONSES OF MR. CREW AND MR. KLEINDORFER

QUESTIONS FOR THE RECORD
FOLLOWING THE HEARING ON APRIL 16, 1997
REGARDING H.R. 22

1. Some witnesses have testified that the price cap index of GDPPI as proposed in H.R. 22 does not take into account the actual input costs of the Postal Service; i.e., labor costs comprising 80 percent of operating costs. For example, Professor Baumol stated that GDPPI is more appropriate for the capital intensive industries where price caps have been applied elsewhere, such as telecommunications, and he argued for consideration of an index that reflects the Postal Service's substantial handicraft components. Further, Dr. Christensen proposed that the Subcommittee consider a blended index of the Employment Cost Index (ECI) and GDPPI, to better reflect the Service's great reliance on labor. However, other witnesses, such as Mr. Sidak, suggest that basing an index on the Postal Service's capital-labor ratio represents flawed reasoning because the current cost mix is neither profit-maximizing nor cost-minimizing. What are your thoughts regarding selection of an appropriate index, and whether a blended index of ECI and GDPPI is appropriate?

    a. Although the bill proposes that the index be set in statute, how important is it that the regulator have discretion to revisit and adjust the index? What would be an acceptable time frame for the regulator to analyze the market, economic, etc., trends underlying the assumptions used in setting the index?

2. H.R. 22 bases the choice of the adjustment, or "X", factor on various measurable considerations such as costs, revenue, productivity, service quality, and demand. However, other witnesses suggest that the adjustment factor be a pure productivity offset. Yet others argue that the current subjective ratemaking criteria in the statute (e.g., fairness and equity, or the educational, cultural, scientific, and information value of the mail) be retained as the adjustment factor criteria. What are your thoughts regarding the establishment of the adjustment factor solely as a productivity offset? If other factors should be considered, which ones?

    a. H.R. 22 permits a positive or negative adjustment factor, as determined by the Postal Rate Commission after a full and open case. However, some have suggested that a positive adjustment factor should be permitted only under certain conditions and that these conditions should be specifically enumerated under the bill. These witnesses have stated that allowing for a positive adjustment factor would negate any cost savings and would send the wrong message to postal managers. What are your thoughts in this regard?

b. Some testimony has recommended that a single adjustment factor be set by the Postal Rate Commission and that this would be the same adjustment factor for each basket. These witnesses have observed that setting individual adjustment factors for each basket places the Commission closer to cost-of-service regulatory decisions. However, others suggest that separate adjustment factors for each basket are necessary to take into account the fairness and equity considerations, among others, that many mailers in the noncompetitive category feel are important among baskets. What are your thoughts in this regard? How best can price changes among baskets be seen as fair and equitable? Would the use of price adjustment floors and ceilings be compatible with – or should they replace – the separate adjustment factors for each basket?

c. Dr. Christensen suggests completely hardwiring the price cap formula by not only setting the index in statute, but also selecting the non-farm total factor productivity index published by the government as an annual adjustment factor. What other price cap regimes are completely hardwired, especially in statute? What are the pros and cons of such a suggestion; (for example, Dr. Christensen cites advantages such as the objectivity of the offset and the avoidance of any regulatory meddling)?

d. What considerations should apply in determining the makeup and number of product baskets? In other words, what are the principles that determine the number and content of baskets?

i. You express some concern as to the makeup of the "baskets" as they are formulated in H.R. 22 and believe that there are too many items in the noncompetitive baskets. What are some possible alternatives to the structure in H.R. 22?

3. The Subcommittee has heard various points of view on the issue of applying antitrust laws to the Postal Service; what do you see as some of the advantages and disadvantages in applying antitrust statutes to the Postal Service, particularly considering its position as a government entity? To what extent should competitive products of the Postal Service be subject to other laws as applicable to similar products of private companies, such as business practices rules (e.g., Lanham Act), customs laws, etc.?

a. Relatedly, some witnesses have suggested that the complaint process for rate complaints be strengthened in H.R. 22 to permit consideration of a complaint by the Postal Rate Commission outside of the annual audit, whereas the bill handles rate complaints as part of the Commission's

annual audit review. Should rate complaints be handled solely, if at all, within the annual audit? Why or why not?

b. How would you reconcile a finding by the Commission in the annual audit that the Service's rates are in statutory compliance with a complaint on those rates that comes forward at a later time? Should the Commission's finding in the annual audit that rates are in compliance with the statutory requirements preclude further complaints before the Commission on those rates? Why or why not?

4. There is a great deal of concern, under the present system, regarding possible cross-subsidization. How does price cap regulation address this particular concern?

   a. Do you feel it is valid to say that under the existing cost-of-service type of ratemaking, the Postal Service is more likely to overprice its monopoly products and services to subsidize its competitive items?

   b. How true is it that cross-subsidies generally reduce a firm's profitability in the long-term?

   c. What are the best ways to insure against cross-subsidization of competitive products from captive customers? In addition to the price cap itself, the requirement that competitive products cover costs and contribute a reasonable amount to overhead, and antitrust action, H.R. 22 authorizes the Postal Rate Commission to require that up to 50 percent of all profits in any given year be applied to limit or reduce prices for non-competitive products when the Commission's annual audit finds that non-competitive prices exceeded the cap, or that competitive ones were not covering costs or contributing reasonably to overhead. Are these disincentives enough; what should be the sanctions if the Commission finds evidence that the Service is cross-subsidizing?

   d. To what extent should Congress limit price discrimination in a commercial activity like postal service where Congress has limited competitive alternatives for buyers through the statutory monopoly? At what point is price discrimination "unfair" or "unreasonable" in a restricted market?

   e. Currently, HR 22 requires each product in the competitive category of mail to cover its attributable costs plus make a reasonable contribution to overhead. To what extent should Congress require the Postal Service to recover a share of overhead ("institutional costs") and cost of capital from

its competitive products collectively? Theoretically, the Postal Service and potentially mailers will benefit if the Postal Service earns one dollar in marginal revenues from competitive markets, i.e., without recovery of any overhead. Likewise, it may be that markets will be distorted and private companies disadvantaged if the Postal Service can compete without the discipline of recovering a fair share of overhead in competitive markets. How should Congress strike a balance between these positions?

f. If Congress requires the Postal Service to recover a share of overhead ("institutional costs") and cost of capital from its competitive products collectively and otherwise comply with the same laws as private competitors, is it reasonable to hope that over time the Postal Service's participation in competitive markets will create an incentive to increase its efficiency in non-competitive markets to the same standards as private industry? Or will the price cap mechanism -- on its own – help increase the Service's efficiency in non-competitive markets without expecting these changes to come from additional requirements on competitive products?

5. The Subcommittee has heard differing views on the need to incorporate oversight of the quality of service in a price cap framework. H.R. 22 includes this review of service performance in the annual audit by the Postal Rate Commission. What are your thoughts on how, if at all, the Postal Service's achievement of its delivery service standards should be overseen in a price cap regime? Should the Commission also have a role in setting those service standards?

6. H.R. 22 permits the Postal Service to experiment with new products and services. How important is this testing authority to an incentive-based regulatory system, and how much freedom should the Postal Service enjoy in testing new products? How much oversight is necessary, particularly to guard against cross-subsidization? For example, what role should a regulator play in the introduction of new products or services by a regulated entity?

   a. Who should determine the placement of new products into price cap baskets; the Postal Service or the Postal Rate Commission?

   b. Should the Postal Service be allowed to provide non-postal services like financial services, electronic postmarks, T-shirts, etc.? Why or why not? If so, under what conditions should they be provided? Can non-postal ventures help underwrite the costs of universal service?

7. Are there specific issues that the Subcommittee should consider when requiring the baseline rate case (H.R. 22 requires a new rate case in order to provide "fresh" rates for the price cap regime if rates were not set or in the process of being set within 18 months of enactment)? Should the Postal Service continue to have sole authority to set its revenue requirement for this last omnibus rate case; are there any specific items that should be built into this particular revenue requirement?

    a. What have been some of the more common parameters utilized in other price cap regimes to insure that the new system is established correctly and "gets off on the right foot?"

    b. Recognizing that existing law requires the Postal Service to operate under a break-even mandate, the current ratesetting process allows for additional revenue in the rate structure to cover contingencies as well as to recover prior years' losses. Should these additional revenue provisions be included for this final rate case? Why or why not?

8. How often should the Postal Service be allowed to increase prices that are subject to the rate cap? H.R. 22 proposes that the Service be permitted once-yearly price increases. Is this appropriate? Should the rate cap be cumulative in nature in that the Postal Service would be allowed to make up for lost increases if it decides to forego a rate increase in one or more years, subject to the cumulative cap?

        a. At what level of the rate schedule should the cap apply? H.R. 22 would apply the rate cap to the subclass level in each basket, thereby permitting the Postal Service the ability to average rate increases among rate categories within a subclass. Should such averaging be restricted through price bands? If so, how?

9. H.R. 22 would allow for an "exigency case" should the Postal Service find that it faces severe financial exigencies and a change in the adjustment factors is needed to restore the Service to fiscal soundness. If the Postal Service requests such a case, the Postal Rate Commission would then decide whether or not to change the adjustment factors that apply during the then current 5 year ratemaking cycle. What are your thoughts on this provision? Under what circumstances, if any, should an exigency case be allowed? What sanctions, if any, should be applied if the Postal Service would seek additional revenue under this procedure?

    a. Instead of the exigency case approach, some witnesses have suggested that the statute specify that the rate cap only be adjusted for specific financial burdens placed on the Postal Service outside of its control, such as Congressional budgetary obligations. How should the rate cap formula

deal with such emergencies? How specific should the statute be regarding the Commission's determinations of exigent costs?

10. Are there particular practices that have been noticed in other industries using price caps that allow the regulated company over time to attempt to dilute the desired incentives and reduce the potential for cost reductions that the regulator, in turn, should be aware of and specifically monitor?

11. Assuming "honest, efficient, and economical management" (the statutory standard in Section 3621 of Title 39) of the Postal Service, how large of a statutory postal monopoly is needed to sustain the current level of universal postal service? How can this question be answered? Do we first need to define universal service? Why or why not? If so, how would you suggest that the nation define universal service in the postal services context?

12. To what extent do "universal service" obligations set by Congress impose additional costs that the Postal Service would not normally and reasonably incur if operated as a private business? How can this question be answered?

13. To what extent could the costs of the universal service obligation be financed by payments from a "universal service" trust fund, such as occurs with the universal service fund in telecommunications?

14. To what extent could Congress reduce the costs of universal service by limiting the uniform rate requirement for letters to single piece letters? Are there any public interest benefits associated with a statutory requirement for uniform rates for *bulk* letters sent by businesses and organizations?

15. Generally speaking, what are the overall costs and benefits of our current approach to regulating postal services in the United States? For example, what are the economic costs resulting from the statutory postal monopoly and related postal laws that limit competition? What are the economic benefits derived from such accomplishments as universal service?

16. Congress enacted the private express statutes in 1845, long before "universal service" was achieved in the United States (about 1915). What economic evidence supports the conclusion that universal service depends on the continuation of the private express statutes?

17. One aspect of the statutory monopoly is the mailbox prohibition. H.R. 22 provides for a limited demonstration project to test broadening access to the mailbox, although H.R. 22 mandates that the test permit citizens to opt out of the test. This demonstration project is primarily intended to test the idea of giving the

citizen a modicum of control over their own mailbox. The citizen, and not the government, would decide on their own whether or not they want others, in addition to the Postal Service, putting mail in the mailbox. To what extent, and based on what evidence, is the mailbox prohibition necessary to provide universal service?

18. H.R. 22 proposes that the scope of the Postal Service's monopoly over the delivery of letter mail be restricted to letters costing less than 2 dollars. What evidence are you aware of, if any, that would indicate how this change would impact the Postal Service, particularly in terms of its revenue?

19. Some of the witnesses have outlined the benefits of price cap regulation over the current cost-of-service regulatory approach. Professor Kwoka enumerates in his testimony that the evidence to date regarding price caps is largely favorable, and Dr. Rose indicates that the experience on the state level has also been successful. Professor Baumol, who some consider the inventor of price caps, noted in his statement that, although the price cap mechanism was designed for the circumstances of a privately-owned, profit-seeking firm that is regulated to prevent the exercise of market power, it is possible to adapt the approach to the Postal Service and achieve positive results. However, other witnesses have taken a less sanguine view about the extent to which price caps will result in improvements. What incentives exist under the current approach – where the Postal Service is permitted to determine its revenue needs and then set prices to fully recover those costs -- for controlling costs and improving efficiency?

    a. Does the fact that the Postal Service lacks private ownership disqualify price caps as an appropriate regulatory scheme for the Service?

    b. To what extent can the managers and employees of the Postal Service serve the economic function of "residual claimants" demanded by price caps through a profit-sharing mechanism? Do the "residual claimants" have to be an outsider such as private shareholders or, perhaps, the Treasury Department in order to reap the efficiency gains promised by price caps?

    c. Some have suggested that the Postal Service pay an annual "dividend" to the federal treasury. Would such a dividend, if set to a certain percentage of any profit, along with the bonuses provided in H.R. 22, help with the lack of strong residual claimants?

20. You appear to indicate that H.R. 22 needs to be more aggressive in approaching deregulation (privatization) of the Postal Service. If the consensus is that we are not ready for such deregulation, even on a phasing schedule, does H.R. 22 remain worth doing?

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June 19, 1997

The Honorable John M. McHugh
Chairman, Subcommittee on the Postal Service
2157 Rayburn House Office Building
Washington, DC 20515-6143

Dear Representative McHugh,

We are pleased to respond to the questions raised in the attachment to your letter of May 20, 1997.

Our remarks should be understood in the context of our Testimony. Absent residual claimants, the benefits of price caps are likely to be sparse. We do not know how to establish residual claimants in the absence of privatization.

We have been purposefully brief in our responses so as to focus attention on what we consider the most important points. If you require clarification or further information, please let us know.

Sincerely yours,

Michael A. Crew
Professor of Economics

Paul R. Kleindorfer
Universal Furniture Professor
of Economics & Decision Sciences

enclosure

RESPONSES TO:
QUESTIONS FOR THE RECORD
FOLLOWING THE HEARING ON APRIL 16, 1997
REGARDING H.R. 22

1. We agree with Dr. Christensen.

1a. The index should be set by statue with the "blending" factors subject to regulatory review at the end of the price-cap period.

2. We are against setting an X factor based solely on a productivity offset. This will lead to complexity and potential problems in attempting to measure X precisely. The real point of X is to ensure ex ante a consumer dividend. (For details see attached special issue of the *Journal of Regulatory Economics* (JRE) on incentive regulation.)

2a. It is important to leave the setting of the X factor to the regulator, possibly with the aid of some general principles (like efficiency, keeping the firm viable, fair sharing of improved efficiency between the firm and its customers, and so forth), which could be mentioned in the legislation.

2b. Only a single adjustment (X) factor should be considered, common across baskets. Anything else will give rise to increased complexity with no real benefits. Inter basket flexibility can be achieved by mechanisms too complex to discuss here. (See attached JRE). We would argue that floors and ceilings (if used) should be common across baskets. These additional details should be left to the regulator to determine.

2c. It does not matter greatly what index is used since the effect of price caps is the combined result of the index and the X factor. We would be against Dr.Christensen's proposal cited in your question on the grounds that it overemphasizes productivity measurements. In the end there is no avoiding regulatory judgment in implementing price caps.

2d. We have nothing to add to our testimony on this matter.

3. As a public enterprise, subject to review by the PRC, the Postal Governors and the Congress, adding requirements under antitrust and other laws would appear redundant.

4. At least for a private enterprise, price-cap regulation does not encourage cross subsidization. The same is not true of cost-of-service regulation. It is therefore not surprising that a great deal of discussion before the PRC in rate cases is concerned with cross subsidization. Note that if price-cap regulation is applied to a public enterprise, the cross subsidy problem may well continue to be a problem.

4a. With the considerable safeguards against cross subsidization by the Postal Rate Commission, serious cross subsidization is likely to be avoided. However, under private ownership and properly designed baskets, incentives against cross subsidy are likely to be even stronger.

4f. Absent residual claimants it is highly unlikely that efficiency will be improved as a result of this mechanism alone.

5. The PRC is well placed to oversee quality standards. Concerning the setting of these, there are well-defined benchmarks for efficient quality (see our earlier book on *The Economics of Postal Service* for details) and these should be used. These benchmarks essentially say that quality (for various services) should be set to levels which equate the marginal benefits of increased quality to the marginal cost of increased quality.

6. A privately owned postal service would have powerful (profit) incentives to introduce new products and not cross subsidize them. The regulators role on new products would be to watch and wait. Even under public enterprise, it is extremely important that the Postal Service have considerable freedom to introduce new products; it will otherwise not find the necessary confluence with the rapidly changing communications marketplace.

6a. The PRC, after an appropriate introductory period of study.

6b. A privatized Postal Service would have complete freedom to sell what it wanted. A public corporation must be subject to oversight. It cannot have complete freedom to play with "the house's money". The issue of which markets a public enterprise should be precluded from entering is

quite tricky. If the oversight is too stringent, the public enterprise will not be sufficiently innovative to survive. If the oversight is too flexible, the public enterprise will likely enter into ventures in which it has no expertise. Not facing the discipline of capital markets, the latter tendency can be very expensive.

7. Under both public ownership and privatization the PRC should set the revenue requirement.

7a. The rate of return on capital would be a critical concern and usually serves as one of the basic tests for determining the level of the price cap and X factors.

7b. Unless previous period losses are recouped or written off, a privatized Postal Service would be financially handicapped. For a public enterprise, and especially under mandatory labor arbitration, it is not clear what the effect of prior years' losses would be. They might provide a signal to hold wages down. But they might simply viewed as someone else's problem, perhaps to be cleared up at the next review period of the price cap. On balance, a price cap should have as few escape routes as possible, so we would favor a fair but rigorous start-up price-cap regime which would be achievable with effort and would guarantee consumers a dividend over time. This means that large prior years' losses cannot be absorbed in setting up the price cap, unless the X factor is low.

8. Prices could be raised annually and the cap would be cumulative, i.e. the Postal Service could bank a price increase.

8a. The cap would apply to all products within the basket rather than just at the subclass level. If Congress wished to constrain changes within the basket, there a several means available which are less restrictive than the current subclass proposal.

9. Normally, if the rate of return on capital drops to a very low level, emergency action would have to be taken. Such problems would largely be avoided if "Y factors" which allow adjustments for exogenous changes are allowed. Whether the Postal Service is penalized (and the nature of such penalties) will depend on the underlying reasons for the relief and whether the Postal Service is a public or private organization. In either case, the

usual language adopted for "exigent costs" are costs imposed though legal or tax changes which were not foreseen at the time when the price-cap regime was (re-)initialized.

10. The potential for quality degradation is considerable and will require vigilance on the part of the PRC.

11. We have argued that a monopoly is one way of addressing the universal service obligation. The scope of the monopoly and the USO would likely both optimally be reduced over time. (See enclosed paper for details.)

12. (See enclosed paper.)

13. It is possible. But it may set up an added bureaucracy. The evolving experience in telecommunications may be instructive in this context. It is our view that the USO question need not be "solved" at the same time that a new governance structure is implemented for the Postal Service. The extent of the USO and its financing will continue to be important problems into the future, whatever the governance structure and form of regulation is implemented.

14. This would reduce the cost. To our knowledge this has never been studied in detail so we have little idea of an estimate of the cost savings. Concerning public interest benefits associated with uniform pricing of bulk letters, there does not appear to be any prima facie for such benefits.

15. (See enclosed paper.)

16. The private express statutes could be modified and universal service could still be provided, as is evident in other countries which provide universal service without these statutes. However, the problem requires a major study.

17. Universal service is provided in the rest of the world without a mailbox monopoly.

18. It would adversely impact the Postal Service's revenue.

19. Professor Kwoka's claim is based primarily on his belief, rather than any evidence, that the successful experience of price caps in the private sector will be repeated in the public sector. We think that this is a highly unlikely scenario. (See our Testimony.)

19a. Price caps are not disqualified for the Postal Service under continuing public enterprise. However, their expected benefits are not likely to be achieved absent clear residual claimants. (See our Testimony.)

19b. In our view, private shareholders and the discipline of capital markets and other markets (e.g., those for managerial talent) are required to have any assurance that efficiency gains will be achieved under price caps. The key logic of price caps is three-fold (for existing products): decoupling revenue from cost; providing incentives to increase unit sales through regulating unit prices and not total revenues; and allowing cost efficiency gains to be fully garnered by the provider between price-cap reviews. All three of these key features become muddled or irrelevant for a public enterprise. One could attempt to resurrect them through an external third party such as the Treasury Department, but this would be roughly akin to the current system in which exhortations are plentiful but information and motivation for cost savings and product innovation are only available internally to the Postal Service. (See our Testimony for additional comments.)

19c. It may have some beneficial short-term effects. However, the various parties would quickly learn to "game the system" leaving the effects uncertain. Nonetheless, given the positive experience in New Zealand and Australia with such dividends, these ideas to help provide some weak residual claimants should be considered.

20. The key question is can H.R. 22 leverage such deregulation and privatization in the longer term? If it cannot, then it will only give price caps and incentive regulation an undeserved bad name, when the real problems are with ownership structure and labor relations, and this would certainly not be worth doing. So, let us rephrase this question slightly as follows: how can H.R. 22 serve to introduce new avenues for deregulation, privatization and better labor relations practices? We would suggest three ideas for your consideration:

- First, the legislation should explicitly commit to the principle of achieving increased market relevance/focus for the Postal Service, including a confluence with labor and capital markets and with the rapidly changing dictates of the communications market place. We are convinced that such relevance will become an absolute requirement for viability of postal services in the next century. Such market focus implicitly embodies the principles of ultimate privatization and reformed labor relations practices and H.R. 22 should recognize these as long-term objectives, even if "we are not ready for such deregulation" at present.

- Second, in particular, the legislation should explicitly commit to exploring ways for Postal Service management to adjust the labor force, both in size and composition, to the changing needs of the market place. As we move toward more technologically demanding products and services and as competition becomes intense, it will be imperative that the Postal Service adapt its labor force to the dictates of the market. Absent a more flexible approach to the composition and remuneration of the labor force, and a real crisis will almost certainly develop soon. The essence of this recommendation is that Congressional Staff, in consultation with experts at the Postal Service, the unions and other labor experts, should determine a set of feasible alternatives for increasing managerial flexibility in managing the labor force. If the legislation cannot politically change labor relations practices, it should at least attempt to increase the leverage of Postal Service management over the level and composition of its key cost driver.

- Third, H.R. 22 should commit to reviewing the progress of the Postal Service towards meeting the objectives of this reform legislation to achieve greater efficiency and better services after a reasonable period of time, say 7 years, with an eye on the possibility of introducing further reforms (e.g., privatization) at that time.

Efficient Entry, Monopoly and the Universal Service Obligation in Postal Service[1]

by

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Paul R. Kleindorfer

May 13, 1997

1. Background

Two primary attributes of traditional postal service are ubiquity of service and uniform pricing. It costs a mailer the same to post a letter for delivery in his home town as it does for delivery in some town at the other end of the country. Similarly, the mailer pays the same whether his letter is addressed to an electric utility that receives thousands of letters a day or whether it is addressed to his aunt living on some outlying farm. Although the costs of a Post Office (PO) are very different in each of these cases, the mailer still faces the same price. This requirement of ubiquity of delivery[2] combined with the uniformity of price, regardless of costs, are the basic ingredients constituting the universal service obligation (USO).

Absent some prohibition on entry the USO would result in entry making it impossible for a PO to meet its USO. On the low cost routes where it is making large surpluses rivals will enter depleting the surpluses it is using to cover the losses in its high cost areas. This notion of a USO and the resultant requirement to secure the PO from entry has been generally accepted for around a century and a half with the success of the Penny Post following its founding in 1840. Recently, however, this notion has come to be questioned for a number of reasons, including the general trend toward promoting competition in all network industries. Thus, over the last ten years or so, partly as a result of technological change, the guaranteed monopolies of network industries everywhere have been questioned,

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[1] The authors are respectively Professor of Economics and Director of the Center for Research in Regulated Industries, Rutgers University, and Universal Furniture Professor of Decision Sciences and Economics, University of Pennsylvania. They have benefitted from discussions on the USO with Ian Reay, Borje Spong and Sture Wallander.

[2] In practice a PO may have other obligations which might be a part of the USO. Perhaps most important PO's are required to provide retail counter service on a ubiquitous basis. The costs of providing such service to outlying areas may not be trivial. In this paper we do not consider such obligations. However, such costs could probably be funded in the same way as we propose here, namely, by enlarging the monopoly.

for example, in gas, electricity, and telecommunications, and public policy has focussed on enabling competition.

Similar forces are at work in postal service and here too the issue is how to design policies to enable competition with all its resultant gains and yet retain almost all the benefits traditionally expected from postal service, including the continuing existence of a USO. One approach to this problem has been that adopted in Sweden, Finland and New Zealand,[3] namely the abolition of monopoly protection, the apparent opening of postal markets to all comers. This "liberalization" approach, however, difficult to maintain along side a meaningful USO, at least in most major economies. Without some monopoly protection the USO may become increasingly untenable. In addition, without a clear monopoly limit it is difficult to define when conduct on the part of the incumbent PO is anti-competitive. For European PO's abolishing the monopoly is particularly problematical since if the statutory monopoly is lifted then EU competition rules (Articles 85-6 of the Treaty of Rome), aimed at reducing dominance, could have a serious impact on a PO's ability to meet its USO, and might impair the Members States's ability to determine its USO according to domestic circumstances. The recent case of Sweden Post and Citymail is compelling.[4] Sweden Post cut its prices for bulk mail in Stockholm and only Stockholm when faced with competition only in Stockholm. Its actions prompted a suit by Citymail. The problem is that Sweden Post was faced with a USO and no monopoly protection. In this case what was its recourse? Should it just let a rival take its profitable business and be left with an increasing amount of high cost business? Absent a monopoly limit, there is no bright-line rule for a PO to employ when faced with such entry.

Faced with these somewhat conflicting developments the current concern in postal service is that entry and substitution for postal service will make the USO increasingly untenable. As it is unrealistic to assume that PO's will be relieved of their USO we are not arguing for a complete liberalization of entry into the postal business but for a much more carefully designed USO and monopoly.[5] Our aim is to promote efficiency in the postal sector. Thus, we are concerned not about competitive entry per se, but with inefficient entry that will damage the ability of the POs to provide a foundation for a more competitive postal sector, while assuring the continuing existence of a USO. This paper develops a framework for evaluating the optimal USO and the implied monopoly or "Reserved Area". There is currently no solid economic foundation for determining the nature and extent of the Reserved Area beyond a sense that it should be reduced. Rather typical of the current approach is a

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[3] Finland has a licensing system. However, the first license to an entrant has yet to be granted since the advent of liberalization in 1995. For a description of the USO and competition in New Zealand, see Allen (1997).

[4] Leskinen (1997) provides an analysis of this and other postal cases.

[5] Nor are we arguing for a universal service fund, which is frequently proposed as a means of funding the USO (for example, Stumpf 1997). Industry subsidies are not exactly renowned for their ability to promote efficiency, passenger railroads being an obvious example. Moreover, we think that current attitudes on government spending make the introduction of such subsidies effectively infeasible at this time.

bill before the U.S. House of Representative (H.R. 3717) proposing major reform of the U.S. Postal Service. The bill proposes to reduce the monopoly so that only items with postage of less than $2.00 are protected by the monopoly.

While the issue of efficient entry has been addressed in a number of papers over the years, there is a need to focus this general literature on the specific attributes of postal service. The central question addressed is thus: under what conditions should entry be permitted where an incumbent monopoly, faced with a USO, has an exclusive franchise? Entry has the potential to improve both static and dynamic efficiency in that service or cost innovations occur when entrants produce a given product or service, or some elements thereof, more economically or with better service quality attributes than the incumbent. By contrast, under a USO, entry may not provide any of these promised efficiency gains.[6] Indeed, where the entrant has higher costs than the incumbent there are clear efficiency losses resulting from the increased costs. Even where an entrant has lower costs than the incumbent the revenue of the incumbent is eroded and the viability of the USO is threatened. This may be especially true if, as in postal services, there are significant cost differences across the service territory and uniform pricing is used. The necessary efficiency balance therefore involves a tradeoff between the efficiency benefits of competitive entry and the economic costs of cream-skimming which the USO, uniform pricing and heterogeneous costs enable. Achieving the proper balance here requires a mixture of pricing approaches, entry restrictions and possible re-design of the USO to decrease cost heterogeneity.

In this paper we are arguing for a much broader definition of the USO. Rather than begin, as in the traditional approach to the USO, with a notion that the USO applies only to end-to-end services and applies only to uniform pricing, we argue that quality attributes are critical to the definition of the USO and that both wholesale and retail services should be considered in determining the scope of the USO and the associated Reserved Area. For efficiency both USO and Reserved Area should be determined simultaneously to balance the benefits of increased uniformity and ubiquity against the costs of a larger Reserved Area. In practice, however, this may take place in two stages. First, the USO is defined and then the minimal Reserved Area necessary to support this USO would be determined. As we discuss below, the efficiency of the resulting USO and Reserved Area can be evaluated through various welfare and cost measures.

In the next section, we analyze in more detail the nature of the USO and the tradeoffs in determining its scope and that of the supporting Reserved Area which are implied by economic efficiency. In section 3 we develop a general model to understand the efficiency conditions implied by these tradeoffs at optimum. In section 4 we develop some of the policy implications of these results. Section 5 is by way of conclusion.

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[6] In the case of Citymail it could be argued that Citymail provided service innovation, such as "day-certain" delivery. However, Citymail delivered only on two days a week.

2. On Defining the USO under Competitive Entry

The question of the nature and extent of the USO is particularly important today given the increased impact of competition on postal and delivery services. Traditionally, the USO has been seen as the requirement to offer standard service at uniform and affordable rates, often coupled with various constraints on the quality of service.[7] The emphasis in the traditional definition of the USO is on the level of cross-subsidy from low-cost routes to high-cost routes implied by uniform pricing if the incumbent postal service provider is to break even. With the advent of competition, both from other postal-type providers as well as from electronic substitutes, maintaining the USO becomes increasingly difficult as cross-subsidies and service quality standards are put under pressure by competitors who can potentially target specific customer segments with customized service offerings.. These same trends suggest generalizing the traditional concept of USO to address better the implicit tradeoffs between the extent of the USO, the supporting Reserved Area and economic efficiency.

For our purposes, we define the USO as a (legal or statutory) requirement on the incumbent PO to provide ubiquitous service at a uniform price, usually in return for certain guarantees or some protection of that provider's franchise to operate, and satisfying restrictions on:[8]

The extent of USO-services offered by the PO;

The quality of USO-services offered by the PO.

Concerning extent, the most common restriction is uniform pricing applied to all non-express letter mail.[9] Given this restriction, the key policy question is how to fund this USO. In Cremer et al. (1997), for example, this question is analyzed by considering the welfare

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[7] Some countries require deliveries six days a week, e.g. U.K., U.S.A., France and Germany, while others, e.g. Sweden and Finland are required to deliver only five days a week. In the U.K. the P.O. is required to make two deliveries on week days in most urban areas.

[8] Thus, the USO could be considered as prescriptions on services which take one of four forms: ubiquity alone; ubiquity with uniform price but no quality restrictions; ubiquity with uniform quality restrictions but no uniform price restrictions; and ubiquity with uniform price and some quality restrictions. We argue that only the last presents any significant problems for analysis.

[9] We exclude parcels from this analysis, although in some countries there remains a USO for parcels as well. Note that, in many countries, including the U.S., only the ubiquity aspect of the USO applies to parcel post. This means that prices for parcels can vary not just by weight but also by route, so that the problems of maintaining the USO are significantly less pronounced for parcels than for letter mail, except in the case of service to very high cost areas like Alaska, where the price is higher but may still be well below cost.

consequences resulting from the relative (in)efficiency of using the incumbent postal provider to cross-subsidize high-cost routes - with or without additional subsidies from general tax revenues (i.e., a USO Fund) - rather than allowing price differentiation between high-cost and low-cost routes. The basic idea underlying this kind of analysis has been understood from the early days of postal service, for example, Hill (1837) and Coase (1947).

Our approach differs from these contributions in that we adopt a "second-best" approach, which considers the relative efficiency resulting from alternative definitions of the USO. In particular, the comparison of the inefficiencies that arise when as a result of uniform pricing with a first-best efficient solution are not especially meaningful in the context of actual postal practice. Rather, we regard the USO as fundamental to the very nature of postal service. It exists not just because the government has a naive belief in the importance of subsidizing outlying areas. The benefits arise from the provision of ubiquitous service at a uniform price. There are transactions cost economies, in both production and consumption, from uniform pricing. In addition, the USO has the advantage of providing some rough-and-ready protection against monopoly exploitation to consumers in high costs areas. The critical issue is what should be the nature and extent of the USO. This is the issue we address in this paper. We explore below the implications of modifications in the traditional broad scope of the uniform pricing restriction to allow greater benefits of competition by limiting the services to which uniform pricing applies. For example, the uniform pricing restriction of the USO might be redefined to apply only to single-piece First Class mail, excluding explicitly bulk mailings. In addition, we consider the possibilities of extending the well-established approach of providing a somewhat lower level of service to the outlying areas.

As noted, the incumbent PO accepts the responsibility of meeting its USO in return for certain guarantees and protections, usually embodied in a Reserved Area, the area of service in which the PO is guaranteed a monopoly. Thus, establishing a USO policy involves designing an appropriate relationship between the extent of the USO and the extent of the Reserved Area. The greater the USO, the greater the monopoly (i.e., Reserved Area) required to finance it. Developing an economically efficient policy for the USO and Reserved Area involves striking the right balance between the efficiency losses associated with monopoly, the transactions cost reductions from uniformity, and potential scale and scope economies in certain parts of the postal value chain.

Our approach differs from other contributions[10] in that we are concerned with the effects of entry on the USO. Our approach implies some monopoly being guaranteed to the PO. We are concerned with the tradeoffs between the extent of the monopoly and the extent of the USO. The problem is to frame USO in such a way that efficiency, competition and commercial operation on the part of the PO are encouraged. Recent contributions to the USO policy debate have been more restrictive in scope, concerned primarily with the efficiency losses associated with uniform pricing by the incumbent PO. These losses are usually referred to as the "Cost of the USO". For example, Elsenbast and Stumpf (1996) examine the nature and extent of the costs created for PO's by the USO and propose a mechanism, a universal service fund, to finance the USO. Dobbs-Golay (1996), on the other

[10] With the possible exception of Stumpf (1997) who discusses some of the tradeoffs involved in determining the nature of the USO.

hand, provide a conceptual basis for measuring the USO cost, including its profitability consequences for a PO, the costs of funding and the "welfare" or efficiency costs to the economy of the USO. Various other developments and estimates of the cost of the USO are analyzed in Crew and Kleindorfer (1997).[11]

In addition to these efficiency losses from uniform pricing (and quality), other potential USO-related efficiency effects include the following:

The extent to which entrants are able to supply services in the reserved area at lower cost than the incumbent.

Improved cost and service innovations in the non-reserved sector through the dynamic effects of competition. The larger the Reserved Area (associated with a broader USO), the lower these benefits.

Reduced transactions costs for customers and the PO associated with increased scope of uniform service. The broader the extent of the USO, the larger these benefits.

The cost effects, especially in downstream delivery, of improved utilization of the incumbent PO's local delivery network implied by a larger Reserved Area.

Analysis of these effects of USO policy need to be integrated with traditional concerns with the efficiency losses associated with uniform pricing (and quality). The objective of USO policy can be understood as striking the right balance between these effects and the breakeven requirement of the incumbent PO. Clearly, this implies significant tradeoffs in the costs and benefits implied by each of the above effects as the Reserved Area and the USO are modified. To analyze these tradeoffs, we develop a model below with the following key features:

1. Break-even operations by the incumbent across all products offered.

2. Uniform pricing by the incumbent in the reserved area with Ramsey pricing across the multiple (monopoly) products.

3. Quality is exogenous to the model, but quality competition could be accommodated in extensions to this model.

4. Non-uniform costs associated with providing the product (or products) to different customers, giving rise to incentives for cream-skimming.

5. A competitive fringe which provides differentiated products in the non-reserved sector in competition with the incumbent.

6. Transactions cost savings for customers resulting from uniform pricing.

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[11] See, e.g., Gallet and Toledano (1997), and Stumpf (1997).

3. Modeling the USO and Reserved Area

As described previously, we develop a model of the efficiency effects arising from the required scope of the USO and supporting Reserved Area. We focus here primarily on price and cost effects, with service quality issues exogenous to the model for the moment. We assume that the incumbent postal provider is guaranteed a protected monopoly for services within the scope of the Reserved Area, and that uniform pricing prevails for all such reserved services. Outside the Reserved Area, the incumbent faces a competitive fringe which is assumed to price its services at cost. The fundamental tradeoff which we wish to capture in this model is between the required breakeven constraint, transactions cost savings resulting from uniform pricing, and the extent of the Reserved Area. The greater the scope, the larger the allocative inefficiencies due to uniform pricing if we ignore transactions costs. In addition, to the extent that competitors could provide reserved services at lower cost than the incumbent, there could be additional inefficiencies from extending the scope of the Reserved Area and thereby not enabling cost-reducing competition.

We begin with some notation. Let "A" be the set of all services, both reserved and competitive, which may be offered. Let $R \subseteq A$ be the set of reserved services. Let T be the set of all delivery areas to be served. We assume that both A and T can be ordered. Indeed, for analytical convenience, we will consider both of them to be subsets of the real numbers. In the case of A, this might be thought of as delineating services by their "weight". In the case of T, the ordering can be thought of as indexing delivery areas from lowest (unit delivery) cost to highest (unit delivery) cost. We define the following unit costs and prices:

$c_m(a,t)$ = unit cost for incumbent of delivery of service a in delivery area t

$c_f(a,t)$ = unit cost for competitive fringe of delivery of service a in delivery area t

$c_u(a)$ = unit transactions cost for customers resulting from nonuniform pricing, $a \varepsilon A \backslash R$

$p(a)$ = unit price (assumed to be uniform) for reserved service $a \varepsilon R$ anywhere at $t \varepsilon T$

$p(a,t)$ = unit price (possibly nonuniform) for non-reserved service $a \varepsilon A \backslash R$ at $t \varepsilon T$

Thus, the "full price" a consumer $t \varepsilon T$ faces in areas where nonuniform pricing prevails is $p(a,t) + c_u(a)$. We assume here that the transactions cost of nonuniform pricing is borne fully by the consumers. There could, of course, be transactions cost savings by the PO resulting from uniform pricing as well but we neglect these here.

Define willingness to pay for consumers of service $a \varepsilon A$ in area $t \varepsilon T$ as $V(x, y, a, t)$, where x is the amount of service provided by the incumbent and y the amount provided by the competitive fringe (we assume some product differentiation between x and y). Representing consumer preferences in the usual quasi-linear form:

$$U(x, y, a, m, t) = V(x, y, a, t) + m$$

where m is the numeraire good, and assuming separability of WTP across services, we have the
following traditional welfare function:

$$
\begin{aligned}
W(R,P) = & \int_{a\in R}\int_{t\in T}\left[V(x(p(a),a,t),0,a,t) - c_m(a,t)\,x(p(a),a,t)\right]dt\,da - F \\
& + \int_{a\in A\setminus R}\int_{t\in T} V(x(p(a,t),c_f(a,t),a,t),\,y(p(a,t),c_f(a,t),a,t),a,t)\,dt\,da \qquad (1)\\
& - \int_{a\in A\setminus R}\int_{t\in T}\left[\left(c_m(a,t)+c_u(a)\right)x(p(a,t),c_f(a,t),a,t) + \left(c_f(a,t) + c_u(a)\right)y(p(a,t),c_f(a,t),a,t)\right]dt\,da
\end{aligned}
$$

Π_m, the profit of the incumbent (the profits of the competitive fringe are zero) is given by

$$
\begin{aligned}
\Pi_m(R,P) = & \int_{a\in R}\int_{t\in T}\left(p(a) - c_m(a,t)\right)x(p(a),a,t)\,dt\,da - F \\
& + \int_{a\in A\setminus R}\int_{t\in T}\left(p(a,t) - c_m(a,t)\right)x(p(a,t),c_f(a,t),a,t)\,dt\,da
\end{aligned} \qquad (2)
$$

where F are fixed costs of the incumbent. Note that the second term in the definition of W(R, P) represents the total benefits in the non-reserved sector and the final term represents the total cost in the non-reserved sector, including the transactions costs of nonuniform pricing. We wish to solve the following Ramsey problem as a benchmark solution:

$$
\underset{P\geq 0,\,R\subseteq A}{Maximize}\left\{W(P,R)\,|\,\Pi_m(P,R)\geq \Pi_0\right\} \qquad (3)
$$

where Π_0 is the required profit level of the incumbent. Forming the Lagrangean $L(\lambda) = W + \lambda\Pi_m$, we have the following first-order condition for a ε R:

$$
\frac{\partial L(P,R,\lambda)}{\partial p(a)} = \int_T\left[(1+\lambda)\left(p(a) - c_m(a,t)\right)\frac{\partial x(t)}{\partial p(a)} + \lambda x(t)\right]dt = 0, \quad a\in R \qquad (4)
$$

Note from utility maximization and our assumption that consumers bear the transactions costs of nonuniform pricing that, for any nonreserved service a ε A\ R, $V_x(t) = p(a,t) + c_u(a)$ and $V_y(t) = c_f(a,t) + c_u(a)$. Thus, we have the following first-order condition for a ε A\ R:

$$
\frac{\partial L(P,R,\lambda)}{\partial p(a,t)} = (1+\lambda)\left(p(a,t) - c_m(a,t)\right)\frac{\partial x(t)}{\partial p(a,t)} + \lambda x(t) = 0, \quad a\in A\setminus R \qquad (5)
$$

<u>Example</u>: Regarding the FOCs for p(a) for a ε R and p(a, t) for a ε A\R, suppose demand functions x(p, a, t) for a given service a ε A have the form $x(p, c_f, a, t) = H(t)D(p,c_f, a)$, with

Example: Regarding the FOCs for p(a) for a ε R and p(a, t) for a ε A\R, suppose demand functions x(p, a, t) for a given service a ε A have the form $x(p, c_f, a, t) = H(t)D(p,c_f, a)$, with $H(t) > 0$ and $H'(t) \geq 0$. Then, setting $k = \lambda/(1+\lambda)$, the above FOCs (4)-(5) can be written as:

$$\int_T H(t)\left[\frac{p(a) - c_m(a,t)}{p(a)} + \frac{k}{\eta(p(a),a)}\right]dt = 0, \quad a \in R \tag{6}$$

$$\frac{p(a,t) - c_m(a,t)}{p(a,t)} = -\frac{k}{\eta(p(a,t),a,t)}, \quad a \in A\backslash R \tag{7}$$

where k ε [0, 1] is the Ramsey number and where elasticity $\eta(p, a) = (\partial x/\partial p)(p/x) = (\partial D(p,a)/\partial p)(p/D(p,a))$. This is a kind of inverse elasticity result, which must be solved with the non-reserved service prices p(a, t) to determine the Ramsey number k so as to satisfy the overall profit constraint for the incumbent. Thus, suppose there is but one reserved service a = R and one non-reserved service N and that we have two areas, h = high cost and ℓ = low cost, with demand and cost parameters as given in the following Table:

	t = h (High Cost)	t = ℓ (Low Cost)
Unit Cost $c_m(R,t)$	$2c_R$	c_R
Unit Cost $c_m(N,t)$	$2c_N$	c_N
Demand for the Reserved Service $x(p,t) = H(t)D_R(p)$	$D_R(p)$	$10D_R(p)$
Demand for the Unreserved Service $x(p, c_f, t) = H(t)D_N(p,c_f)$	$D_N(p,c_f)$	$10D_N(p,c_f)$

Then the FOCs reduce to the following for this example[12]:

[12]The reader will note that we have, for this example, assumed a finite or discrete set of delivery regions. The translation of the above (continuous) results to this case should be clear.

$$\left(\frac{p_R - 2c_R}{p_R}\right) + 10\left(\frac{p_R - c_R}{p_R}\right) + \frac{11k}{\eta_R} = 0 \tag{8}$$

$$\frac{p_{Nh} - 2c_N}{p_{Nh}} = -\frac{k}{\eta_{Nh}} \tag{9}$$

$$\frac{p_{Nl} - c_N}{p_{Nl}} = -\frac{k}{\eta_{Nl}} \tag{10}$$

where $\eta_R = pD_R'(p)/D_R(p)$ is the elasticity for the reserved service, $\eta_U = pD_U'(p)/D_U(p)$ and where $k \in [0, 1]$ must be set sufficiently large to ensure prices for this reserved service and for the non-reserved services which will ensure breakeven operations for the incumbent.

For this example, first-best prices are easily obtained from the above FOCs by setting $k = 0$. Doing so yields: $p_R = 12c_R/11$; $p_{Nh} = 2c_N$; and $p_{Nl} = c_N$. Note that the p_{Nt} are just marginal cost prices, while p_R is the welfare-optimal uniform price, an average (with weights proportional to the slope of the demand function in each zone) of the marginal costs of the high and low-cost delivery zones. This example illustrates the basic tradeoffs or sources of inefficiency in determining the USO and associated prices: one is w.r.t. to the Ramsey effect and the need to depart from first-best conditions in order to meet the incumbent's breakeven constraint; the other is the need to impose uniform pricing to avoid transactions costs for consumers (and perhaps also producers) arising from spatially differentiated pricing. The reader will note that the unit transactions cost $c_u(a)$ of nonuniform pricing does not appear anywhere explicitly in the example. It is nonetheless present in that the appropriate price to include in demand for non-reserved services $x(p, c_p, a, t) = H(t)D(p,c_p,a)$ is the full price faced by the consumer, i.e. $p = p(a,t) + c_u(a)$. As $c_u(a)$ increases, clearly demand for the non-reserved service decreases, placing an increased burden on the reserved sector for a fixed breakeven constraint. To examine the impact of this tradeoff further, let us now consider conditions determining the welfare-optimal size of the reserved area.

We wish to examine the scope of the welfare-optimal Reserved Area. For analytical convenience, we assume that R and A are both intervals in the real line, with R having the form $R = [0, r] \subseteq A = [0, \hat{a}]$. We think here of R being restricted to services of a given weight or price range. Given these conventions, the welfare function (1) and profit function (2) are functions of the cutoff point "r" defining the reserved area, i.e.

$$
\begin{aligned}
W(R,P) = & \int_0^r \int_{t\in T} \left[V(x(p(a),a,t),0,a,t) - c_m(a,t)\, x(p(a),a,t)\right] dt\, da \; - \; F \\
& + \int_r^d \int_{t\in T} V(x(p(a,t),c_f(a,t),a,t), y(p(a,t),c_f(a,t),a,t),a,t)\, dt\, da \\
& - \int_r^d \int_{t\in T} \left[\left(c_m(a,t)+c_u(a)\right) x(p(a,t),c_f(a,t),a,t) \; + \; \left(c_f(a,t) \; + \; c_u(a)\right) y(p(a,t),c_f(a,t),a,t)\right] dt\, da
\end{aligned}
\tag{11}
$$

and

$$
\begin{aligned}
\Pi_m(R,P) = & \int_0^r \int_{t\in T} \left(p(a) \; - \; c_m(a,t)\right) x(p(a),a,t)\, dt\, da \; - \; F \\
& + \int_r^d \int_{t\in T} \left(p(a,t) \; - \; c_m(a,t)\right) x(p(a,t),c_f(a,t),a,t)\, dt\, da
\end{aligned}
\tag{12}
$$

Thus, to solve the problem (3) for the optimal size of the reserved area r, we form the Lagrangean $L(\lambda) = W + \lambda\Pi_m$ as before, but using (11)-(12) in place of (1)-(2), and differentiate L w.r.t. r, obtaining:

$$
\begin{aligned}
0 = \frac{\partial L(r,P)}{\partial r} = & \int_{t\in T} \left[V(x(p(r),r,t),0,r,t) - c_m(r,t)\, x(p(r),r,t)\right] dt \\
& - \int_{t\in T} V(x(p(r,t),c_f(r,t),r,t), y(p(r,t),c_f(r,t),r,t),r,t)\, dt \\
& + \int_{t\in T} \left[\left(c_m(r,t)+c_u(r)\right) x(p(r,t),c_f(r,t),r,t) \; + \; \left(c_f(r,t) \; + \; c_u(r)\right) y(p(r,t),c_f(r,t),r,t)\right] dt \\
& + \lambda\left[\int_{t\in T} \left(p(r) \; - \; c_m(r,t)\right) x(p(r),,r,t)\, dt \; - \; \int_{t\in T} \left(p(r,t) \; - \; c_m(r,t)\right) x(p(r,t),c_f(r,t),r,t)\, dt\right]
\end{aligned}
\tag{13}
$$

To provide some insight on the implications of this FOC, let us define the following quantities:

$$W(r,P;R) = \int_{t \in T} \left[V(x(p(r),r,t),0,r,t) - c_m(r,t)\, x(p(r),r,t)\right] dt \tag{14}$$

$$\begin{aligned} W(r,P;N) = & \int_{t \in T} V(x(p(r,t),c_f(r,t),r,t), y(p(r,t),c_f(r,t),r,t),r,t)\, dt \\ & - \int_{t \in T} \left(c_m(r,t)\, x(p(r,t),c_f(r,t),r,t) + c_f(r,t)\, y(p(r,t),c_f(r,t),r,t)\right) dt \end{aligned} \tag{15}$$

$$TC(r,P;N) = \int_{t \in T} c_u(r)\left(x(p(r,t),c_f(r,t),r,t) + y(p(r,t),c_f(r,t),r,t)\right) dt \tag{16}$$

$$\Pi_m(r,P;R) = \int_{t \in T} \left(p(r) - c_m(r,t)\right) x(p(r),r,t)\, dt - F \tag{17}$$

$$\Pi_m(r,P;N) = \int_{t \in T} \left(p(r,t) - c_m(r,t)\right) x(p(r,t),c_f(r,t),r,t)\, dt - F \tag{18}$$

We can note the following interpretation for each of the above expressions:

W(r, P; R) = Welfare obtained from service r if r is in the reserved area (r ε R)

W(r, P; N) = Welfare obtained from service r if r is not in the reserved area (r ε A\R)

TC(r, P; N) = Transactions Costs of service r if r is not in the reserved area ($r \varepsilon A \backslash R$)

$\Pi_m(r, P; R)$ = Incumbent Profit from service r if r is in the reserved area ($r \varepsilon R$)

$\Pi_m(r, P; N)$ = Incumbent Profit from service r if r is in not in the reserved area ($r \varepsilon A \backslash R$)

Using the definitions (14)-(18), we can rewrite the FOC (13) for the optimal scope of the reserved area as follows:

$$W(r,P;R) - (W(r,P;N) - TC(r,P;N)) + \lambda(\Pi_m(r,P;R) - \Pi_m(r,P;N)) = 0 \qquad (19)$$

This equation consists of three terms: The first two terms represent the change in welfare if service r is transferred from the reserved sector to the unreserved sector. The third term represents the product of λ times the change in incumbent profit if service r is transferred from the reserved sector to the unreserved sector. The sum of these three terms is to be set equal to zero as a requirement for the final service added to the reserved sector. The following assumptions concerning the variables above seem reasonable:

1. W(r, P; R) - W(r, P; N) is positive for small r and decreasing in r: This assumption relies on the notion that there are significant scale and scope economies for traditional letter mail (i.e., for small r). However, for other classes of mail, two additional effects tend to erode this initial advantage of the incumbent: the benefits of consumer choice which would be foreclosed if r is reserved and the possible efficiency advantages of the competitive fringe foregone if r is reserved.

2. TC(r, P; N) is positive and decreasing in r: This assumption relies on the notion that unit transactions costs are nonincreasing as weight or price increase (i.e., as r increases) and that unit volumes decrease as r increases.

3. $\Pi_m(r, P ; R) - \Pi_m(r, P ; N)$ is positive and decreasing in r: Incumbent profits for any service when offered as a monopoly service presumably are greater than when the same service is offered in the non-reserved, competitive sector. The consequences of opening traditional letter mail (i.e., when r is small) to unreserved competition would presumably lead to greater losses in profits through cream-skimming and the like than the lower profit margin and lower volume sectors associated with larger r.

Under assumptions 1-3 above, we can graph the likely behavior of the FOC determining the optimal size of the reserved sector as shown in Figure 1 below. There we show three curves, building successively on each other. The lowest curve, ΔW, is the difference W(r, P; R) - W(r, P; N), which is assumed to decrease as r increases. The next is the sum of the first curve and TC(r, P; N), the latter of which is expected to decline as r increases. The highest is the sum of all terms in (18), which given our assumptions must also decline. The optimal scope of the reserved area is where the FOC is stationary, the point r* in Figure 1. As expected, as transactions costs increase, r* will move to the right, i.e. the reserved area will increase, since increases in TC will move the sum of all terms in (18) up and to the right. For analogous reasons, as the profit constraint becomes more binding, i.e.

as λ increases because Π_0 in (3) increases or because F increases, the scope of the reserved area will increase. On the other hand, if the welfare gains from expanding competition increase, then r* will decrease because W(r, P; R) - W(r, P; N) would then decrease.

It would be interesting, at least for some specific functional forms, to verify the reasonableness of the above arguments in more detail. Perhaps a more fruitful approach would be an empirical investigation, motivated by the above theoretical foundations, on the optimal scope of the reserved area. What can be noted on the basis of the above type of modeling is that the USO implies a number of conflicting tradeoffs for efficiency. These include foremost the following:

The benefits of uniform pricing in decreased transactions costs and the welfare losses of uniform pricing through distortions between prices and marginal costs.

The benefits provided by the rough-and-ready consumer protection, particularly to high cost routes, implied by the uniform pricing versus the efficiency losses resulting from cross subsidy

The benefits of competition, both static and dynamic, and the necessity to provide the incumbent with the opportunity to earn sufficient revenues for breakeven operations, particularly in the face of uniform pricing and ubiquity constraints under the USO.

The benefits of a larger reserved area on increased scope of Ramsey pricing versus the cost of competitive benefits foregone.

As required surplus for the incumbent increases, all of the above tradeoffs are exacerbated, and the required reserved area in particular must be increased.

4. Some Research and Policy Implications

The USO is currently the subject of considerable concern. At a time when postal service is facing increased competition from electronic communication it is also facing increased competition from other delivery service providers. This has taken the form of innovative courier service which employs advances in telecommunications and computers to provide a price system of tracking and tracing, as well as guaranteed on time delivery. Similar innovations have been applied to package service. Such innovations represent serious competition to the express and parcel services provided by incumbent postal services. With the growing strength of competitors has come demands for abolition or, at least, a drastic reduction in the postal monopoly. The USO could quite easily become a casualty of the process of liberalization unless it is placed on a much firmer footing. The firmer footing we propose is to develop a mechanism for defining an "efficient" USO, and we begun this process by developing the stylized model of Section 3. However, we see our efforts as a start in the process of defining the USO and developing an environment where competition can flourish according to a set of clear and well accepted rules.

In this section we examine some of the directions this approach to the USO might take and some of the implications it might have for the structure of postal service. Throughout

we maintain our position that the USO is to be funded through a postal monopoly and that this monopoly will be no larger than required to fund the USO. We leave it to others to consider alternative approaches that require explicit subsidies and taxes. For example, the USO might be funded by a tax on all postal and delivery service. We do not expect that such an idea is politically feasible in the current environment or likely to be very efficient. All kinds of small operators of cream-skimming local services would probably find it relatively easy to evade the tax. Collecting the tax might also be costly. However, supporters of such an explicit tax-subsidy approach might find our transactions cost approach a reasonable means of analyzing the problem. We will not consider this approach further but will now proceed to examine some of the implications of our approach.

Our approach might be considered an early attempt to provide a more analytical basis than heretofore for determining the nature and extent of the USO and its impled monopoly protection or reserved area. While our approach to modeling the USO does not take into account all of the tradeoffs between benefits and costs it does provide a means of determining the extent of the USO, which has previously not been examined. At a time when the future of the USO is uncertain because of changes in the postal monopoly in several countries it is important to have a basis for determining the USO and the resultant monopoly protection. Current developments in the U.S. provide a case in point. Under H.R. 3717 there is a proposal to reduce the monopoly limit in the US to $2.00 from the current $3.00 or twice the first-class postage whichever is greater. The drafters of H.R. 3717 argue that, since it represents 80% of the Postal Service's revenue the proposed $2.00 limit will "ensure that the Postal Service is provided sufficient revenue to carry out its statutory mandate to American public."[13] The approach of H.R. 3717 is certainly correct to be concerned with the effect on revenue of changing the monopoly limits, but this is only part of the problem. By considering not only the revenue consequences of a change in the monopoly limit but by attempting to determine the efficient size of the USO our approach breaks new ground and attempts to put changes in the monopoly limit on a much sounder footing. It is very important that changes in the monopoly be considered along with the USO if economic efficiency is to be attained and if a framework is to be developed in which both the incumbent postal services and competitors potentially can benefit. In the US our approach would likely result in a reduction of that monopoly limit if at the same time there is an attempt to define an efficient USO, as the USO would likely be reduced as well. However, our approach provides no basis, absent further analysis of the actual benefits and costs, for the figure of $2.00. There may be additional reasons for choosing $2.00 including the preference for a round number. Our approach, by focussing on some the tradeoffs involved would highlight the importance of the various residual issues involved in determining the nature and extent of USO.

The USO is a very timely issue given the competitive changes facing postal service worldwide. If there is to be a USO there has to be some guaranteed monopoly or some form of explicit subsidy. While our approach supports the continuation of a USO supported by monopoly protection its likely practical impact is a modified and probably reduced USO and correspondingly reduced reserved area, at least in come countries. Our approach is part of

[13] The Bill also offers some increased commercial freedoms to the Postal Service, which presumably are taken into account in proposing the $2.00 limit.

a debate and re-thinking of universal service which is currently taking place. It is certainly not the last word. A number of other issues should be considered in the context of the optimal design of the USO, some of which we outline below.

Traditionally, incumbent postal operators have provided a somewhat reduced level of service to outlying areas. Our approach would call for a further re-examination of the role of service standards in defining the optimal USO. For example, outlying areas might receive service three days a week instead of the typical five or six currently. In other areas Saturday service might be eliminated. In the U.K. twice daily deliveries might be eliminated in most areas. Another variable to consider might be slower delivery. For example, in the case of First Class post in the U.K., instead of providing service on the next business day, First-Class service would be redefined for outlying areas to mean service on the second business day. Currently, reliability tends to be lower to outlying areas. This would also be part of the service dimension. Reducing the standard of service might be considered an alternative to further reduction in reliability.

Enabling competition to foster while preserving a USO requires that the monopoly limit be defined very carefully, as we have argued above. Indeed, the definition of the monopoly is likely to be more complicated than the approach we and others have employed, which is one-dimensional. The monopoly is defined in terms of one dimension, usually a monetary limit.[14] Under competition it is likely that at least a two-dimensional approach would be required. The monopoly, for example, might be defined not simply as a monetary or weight limit but as a monopoly in local delivery and a monetary limit for traditional end-to-end service. This kind of approach would have a number of advantages from the point of view of encouraging effective competition and providing opportunities for incumbent postal services not only to compete vigorously but also to share in the growth of their competitors. It would also provide a means potentially of lowering the cost of the USO.

Under a scheme which guaranteed a postal service a monopoly on local delivery[15] in addition to traditional end-to-end service if monopoly were defined in terms of weight the system would imply different monetary values of the monopoly for the two types of service, since local delivery would be cheaper than end-to-end service. Under a monetary-limit approach the end-to-end weight would have to be less than the local delivery weight if the same monetary limit were set. Neither of these problems seem significant. Defining the monopoly is slightly more complicated as it has two dimensions to it, - end-to-end service and access to the local delivery network (access).

One advantage of defining the monopoly in two dimensions is that it recognizes the inherent natural monopoly in local delivery and it allows competition in all the other functions of postal service. In addition, it provides a clear statement of the limits of the

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[14] It could also be defined in terms of weight. However, defining the limit in terms of both weight and price would not add a dimension, since one is price and the other is quantity!

[15] Local delivery would be a bulk or wholesale service e.g. downstream access on the part of other carriers and bulk mailers.

monopoly and virtually eliminates the possibility of inefficient entry or cream-skimming from higher cost entrants. For example, entrants who provide delivery within a restricted low cost area are able to undercut the incumbent's end-to-end price but are unlikely to be able to undercut the incumbent's access price to the local delivery network. Of course, even if the entrant were able to provide end-to-end restricted local service at a lower price than the incumbent he would not be allowed to as this would be in breach of the monopoly.[16]

Emphasizing the local delivery monopoly makes for a smaller reserved area in end-to-end service more feasible, thus opening up the benefits of competition. The monopoly in local delivery combined with increased competition elsewhere is likely to foster increased demand for local delivery service,[17] providing the incumbent with an increased contribution from local delivery that can help finance the cost of the USO.

Focussing on local delivery is likely to sharpen up the kind of costs analysis that will make for a better understanding of how the costs of the USO arise and, ultimately, how to calculate them more accurately. This, in turn, may lead to more efficient prices, thereby reducing the extent of the reserved area. One example of how more efficient prices may result from the unbundling of the local delivery monopoly arises from the opportunity that unbundling would provide to offer different prices for local delivery in different areas. For example, delivery networks might be classified according to cost categories - High, Medium, Low - and access prices would be set accordingly.[18] While this would increase transactions costs the impact would likely be small because local delivery would be a wholesale service not available to single piece mailers. A further advantage of this approach would be that the prices charged for local delivery did not cross subsidize one another to any great extent. They could still include some contribution to the total USO. For example, local delivery prices could be marked up using the Ramsey rule to contribute to cover fixed costs including the cost of the USO.

Explicitly incorporating the local delivery monopoly into our model for determining the optimal USO and its funding goes well beyond the scope of this paper. For the moment, it will remain a topic for future consideration. Explicitly defining the local delivery monopoly has several advantages. It adds greatly to a better understanding of how costs arise in postal service and therefore to how optimal prices and the USO should be set. In addition, it makes (cream-skimming) entry by higher cost firms much more difficult which, in turn, makes the funding of the USO more secure.

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[16] It may be unnecessary to define the monopoly in terms of local delivery if, indeed, the incumbent has a true (or sustainable) natural monopoly. However, in the absence of information on this we err on the side of caution by defining the monopoly to include access.

[17] While there are some obvious differences, and while technological change is very rapid in telecommunications, a large increase in the demand for access followed the opening up of long distance service to competition.

[18] It is beyond the scope of this paper to go into the details of how prices would be set.

5. Concluding Comments

With the desire on the part of governments and with advances in other communications technologies postal service will be forced to become more efficient. This implies that universal service obligations will have to be reconsidered and in many cases the USO's will have to be reduced or modified. In this paper we have attempted to show how an efficient USO might be determined. The government would implicitly be required to determine the value of the transactions costs in arriving at the optimal USO. This approach differs from existing approaches in that it explicitly focusses on the relevant quantities for decision making. It would also be attractive in terms of its ability to offer legitimation of the monopoly. The monopoly would be driven explicitly by the USO and would be no larger than needed to cover the costs of the USO. To make this approach to the USO effective other changes, for example, the explicit monopoly in local delivery, and regulatory changes to encourage efficiency would be required. Perhaps, these would be the subject of further research papers and policy papers.

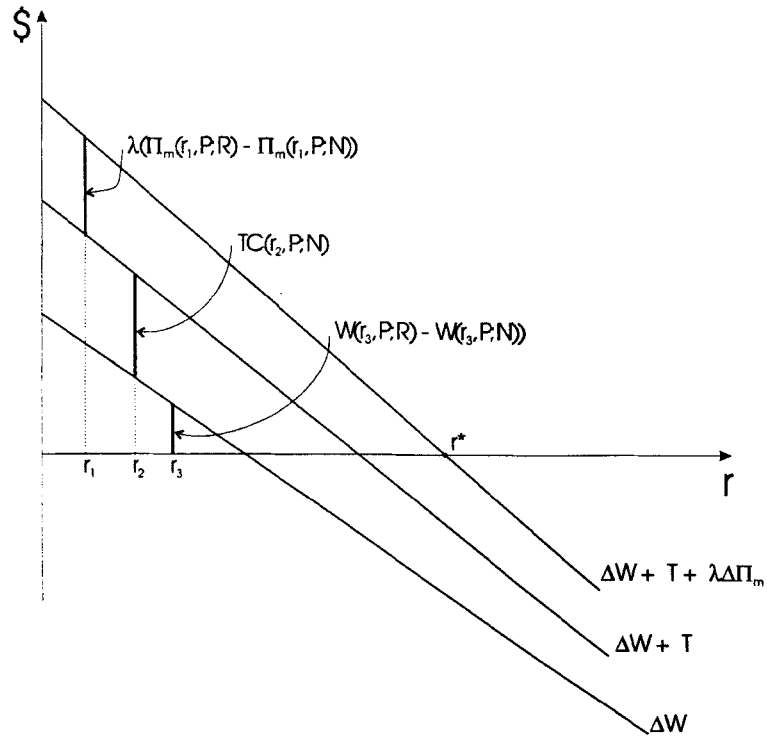

Figure 1. Determining the Scope of the Researved Area

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Mr. McHUGH. As a politician now for longer that I care to admit, I have heard a lot of jokes about politicians. One of the first jokes I heard about nonpoliticians, the old joke about if you took all the economists in the world and laid them end to end, they wouldn't reach a conclusion, ha, ha, ha. Whoever had first said that had never had an opportunity to talk to you gentlemen, because you obviously have some very strongly held opinions, and I say that with admiration. And we have gotten some very clear differences, and that's important to us. If it were not, we would have stacked this panel one way or another. Some thought we were attempting to do that, but through collegiality we avoided that today, and I thank you again.

I would note before we lower the gavel that our next hearing will be with the Postmaster General, a rescheduling, for next Thursday, a week from this coming Thursday, on April 24th, at 1 p.m., currently scheduled for room 2247 in the Rayburn House Office Building.

With that, thank you all for being here. The committee is adjourned.

[Whereupon, at 12:17 p.m., the subcommittee was adjourned.]

[Additional information submitted for the hearing record follows:]

Statement of Dr. Laurits R. Christensen
Chairman
Laurits R. Christensen Associates, Inc.

I wish to thank Congressman McHugh and the Subcommittee on the Postal Service for providing me the opportunity to state my views on H.R. 22. I am a professional economist with a Ph. D. from the University of California at Berkeley. I served as Professor of Economics at the University of Wisconsin for twenty years, specializing in productivity theory and measurement. My firm, Christensen Associates, has provided consulting services to the Postal Service for the past fifteen years. One of my principal activities for the past fifteen years has been formulating and implementing incentive regulation plans, such as the one embodied in H.R. 22, for the U.S. railroad, telecommunications, and electric utility industries. My views on H.R. 22 reflect my knowledge gained from all of the above experiences. See my attached bio for further information on my education and employment experience.

Price Cap regulation has been successfully implemented in the U.S. railroad and telecommunications industries, and it can be successfully applied to the U.S. Postal Service. In order to achieve success, however, the Price Cap plan must be carefully crafted to reflect the Postal Service's unique characteristics.

The Price Cap formula contained in H.R. 22 is quite similar to that employed in the U.S. telecommunications industry. It has been called a "GDPPI-X" formula, since it allows rate increases to equal the increase in overall inflation, as measured by the Gross Domestic Product Price Index, less a productivity offset, or X factor. (H.R. 22 refers to the X factor as an adjustment factor, but it plays exactly the same role as the productivity offset in the telephone Price Cap plans.) While this formula is appropriate for the telecommunications industry, it could create severe financial problems if applied to the Postal Service.

A primary reason that financial problems could arise is that the Postal Service is a much more labor intensive organization than the telecommunications industry. Approximately 80 percent of Postal Service costs are labor compensation (wages and benefits of Postal Service

employees), but only 25 percent of telecommunications industry costs are labor related. Historically, labor compensation in the U.S. economy has grown more rapidly than general inflation, and therefore the GDPPI understates the inflation in input prices faced by the Postal Service.

Chart 1 demonstrates how labor compensation has grown more rapidly than general inflation. Here I compare the GDPPI with the comprehensive measure of labor compensation published by the U.S. Bureau of Labor Statistics: the Total Compensation Employment Cost Index (ECI). Between 1985 and 1996, the ECI increased by 52 percent while the GDPPI increased 40 percent.

A properly crafted Postal Service Price Cap index should include an inflation index (called an Input Price Index) that reflects this reality. This can be accomplished by using the ECI as a primary index and GDPPI as a secondary index. Specifically, the ECI should be given a weight of 80 percent and the GDPPI a weight of 20 percent in computing the change in the Input Price Index, to recognize the fact that 80 percent of Postal Service costs are labor related.

The second feature of a properly crafted price cap plan is the specification of an appropriate productivity offset, or X factor. Here I have two areas of concern regarding H.R. 22. First, H.R. 22 gives a list of six diverse factors to be used in determining the X factor: value of the product to the sender, cost to the Postal Service, productivity, revenue, level of service, and other "mutually agreed upon" considerations. Second, H.R. 22 states that separate X factors should be determined for single piece First-Class mail, bulk First-Class mail, Periodicals, and Standard mail. I believe that the language of the bill will lead to extensive administrative proceedings, where the X factors will ultimately be based on political concerns instead of sound economics.

An appropriate Price Cap Index should mimic price formation in competitive markets. In competitive markets total factor productivity links inflation in output prices to inflation in input prices. Therefore the X factor

should be based on a reasonable total factor productivity target for the Postal Service. I believe that private nonfarm business total factor productivity, as published by the Bureau of Labor Statistics, provides such a target. By explicitly basing the X factor on private nonfarm business total factor productivity, the regulatory process would be streamlined and made fairer.

The Postal Service Price Cap Index should have a third element, which is missing from H.R. 22. Namely, it should include a factor for significant changes in costs outside the control of the Postal Service. Such a factor, called a Z factor, is present in the telephone Price Cap plans. The Z factor would allow the Postal Service to adjust rates for significant changes in tax laws, accounting regulations, regulatory policies, and government appropriations and assessments.

Rather than basing the Price Cap Index on a GDPPI-X formula, with the ground rules for determining X vaguely stated, I believe that the Postal Service Price Cap Index (PCI) should have the following elements: an Input Price Index composed of the ECI (with an 80 percent weight) and GDPPI (with 20 percent weight), a productivity offset based on private nonfarm business total factor productivity, and a Z factor for events outside the control of the Postal Service. Based on an analysis which I describe below, I conclude that the Postal Service Price Cap Index I describe is fairer than the GDPPI-X formula.

Chart 2 compares the Postal Service PCI with the GDPPI for the years 1985-1996. The chart shows that the GDPPI-X formula presents a substantially tighter cap than the Postal Service PCI, even if the X factor is set to zero. The chart also shows GDPPI-X where X is set to 0.5%. One can also calculate the gains and losses that the Postal Service would have faced historically under these three alternative formulas. The result of such an analysis is presented in Table 1. Over the 1985-1996 period, the Postal Service PCI would have allowed the Postal Service to essentially break even.

GDPPI would have resulted in losses amounting to $7 billion. Including an X factor of 0.5% to the GDPPI would have led to $21 billion in losses.

Without changes in the Price Cap formula, it is likely that H.R. 22 would lead to large financial losses for the Postal Service, and Price Cap regulation would eventually have to be abandoned. It is my recommendation that the formula be corrected to prevent this outcome.

There are a few other issues relating to H.R. 22 that I would also like to address. The first issue is the application of the Price Cap Index. H.R. 22 applies the Price Cap Index at the "further subordinate unit" level. Furthermore H.R. 22 defines a "competitive category" of services for which prices are not regulated by the Price Cap Index. Rather, a price floor is established, based on attributable cost plus a "reasonable" contribution to common costs. Applying the Price Cap Index at the further subordinate unit level and requiring products in the competitive services group to make a reasonable contribution to common costs represent a continuation of cost of service regulation.

There is no compelling reason for special treatment of the services found in the competitive group. The mission of the Postal Service has been to provide universal service at reasonable cost. Private carriers, however, have entered markets that had been served exclusively by the Postal Service. To the extent that the private carriers succeed in winning low-cost customers ("cream skimming"), the Postal Service's job of maintaining universal service for the remaining customers is made more difficult. While the Price Cap plan should include rules that prevent the Postal Service from pricing any products below incremental cost, there is no reason to provide additional protection to the Postal Service's competitors. Therefore, I believe that the services in H.R. 22's competitive category, except for international mail, should be regulated by the Price Cap Index, just as the other prices are. International mail has already been deregulated; and it would be a regressive step to re-regulate it.

I also believe that the Price Cap Index should be applied at the basket level, not the further subordinate unit level. I also believe that it would be appropriate to have only three baskets: single piece First-Class mail, Periodicals, and other mail (excluding international). I see no compelling reason to distinguish bulk First-Class mail from Standard mail; many Postal Service customers use both of these types of mail. Within each of the baskets, I believe side conditions could be established on individual rates, in order that no individual mailer would experience large rate increases. This approach is similar to that employed in the telephone Price Cap plans. For example, the AT&T plan had only three baskets (residential service, business service, and "800" service) with the Price Cap Index applied at the basket level. Side conditions, called pricing bands, further limited price increases for individual rates.

By applying the Price Cap Index at the basket level, the Price Cap plan allows for the pricing flexibility needed to respond to changing market conditions. The side conditions protect customers from the possibility of "price gouging." Furthermore, by requiring that the prices of all services cover their incremental cost, the Price Cap plan would protect against cross-subsidization. Such a Price Cap plan addresses the pricing issues that need to be addressed; additional rate regulation would be counter-productive.

Another issue is the increased regulatory oversight given to the Postal Rate Commission and the removal of antitrust immunity under H.R. 22. The Postal Service Board of Governors plays a significantly different role than the Board of Directors in a private corporation. The Board of Governors is appointed by the President of the United States and has the responsibility to provide affordable and effective universal service while maintaining a financially viable Postal Service. Given the Board's responsibilities to provide for the public interest, the level of oversight appropriate for a private utility does not seem appropriate for the Postal Service. The current regulatory oversight exercised by the Postal Rate Commission and the authority of the new, independent Inspector General should suffice.

Increased regulatory oversight by the Postal Rate Commission and antitrust oversight by the Department of Justice and Federal Trade Commission is unwarranted. Furthermore, fear of personal liability under the antitrust laws may discourage qualified individuals from accepting appointment to the Board.

One area of oversight that H.R. 22 transfers to the Postal Rate Commission concerns service. There is no apparent reason why this transfer of authority is necessary. Moving to Price Cap regulation does not imply that the Postal Service will reduce service. The Postal Service will need to focus on maintaining customer satisfaction under Price Caps, or it will risk losing its customers to other forms of communication. If additional monitoring of service is inevitable, care must be taken that the measures of service used correspond with the market demand for service. For example, if Standard mail customers desire reliable service rather than speed, the service measure for Standard mail must be based on reliability.

I have identified areas of H.R. 22 that I feel must be revised for Price Cap regulation to succeed for the Postal Service. If these changes are made, I believe that the viability of the Postal Service will be enhanced, and that Postal customers, Postal employees, and the American public will all benefit.

Chart 1
ECI and GDPPI, 1985-1996

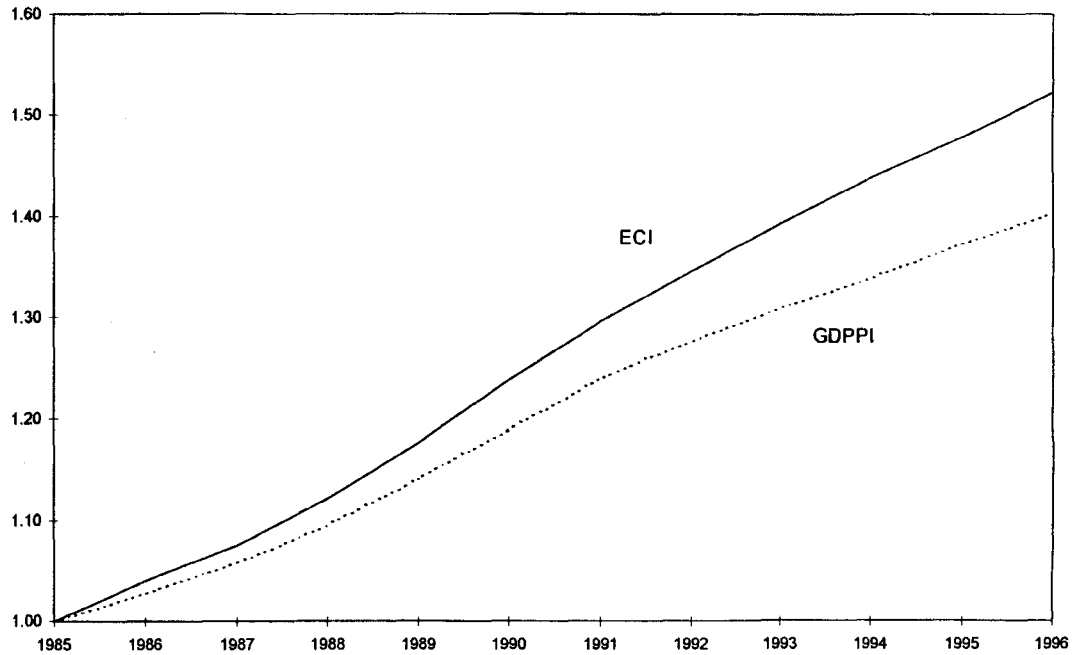

Chart 2
Comparison of Postal PCI with GDPPI and GDPPI-0.5%

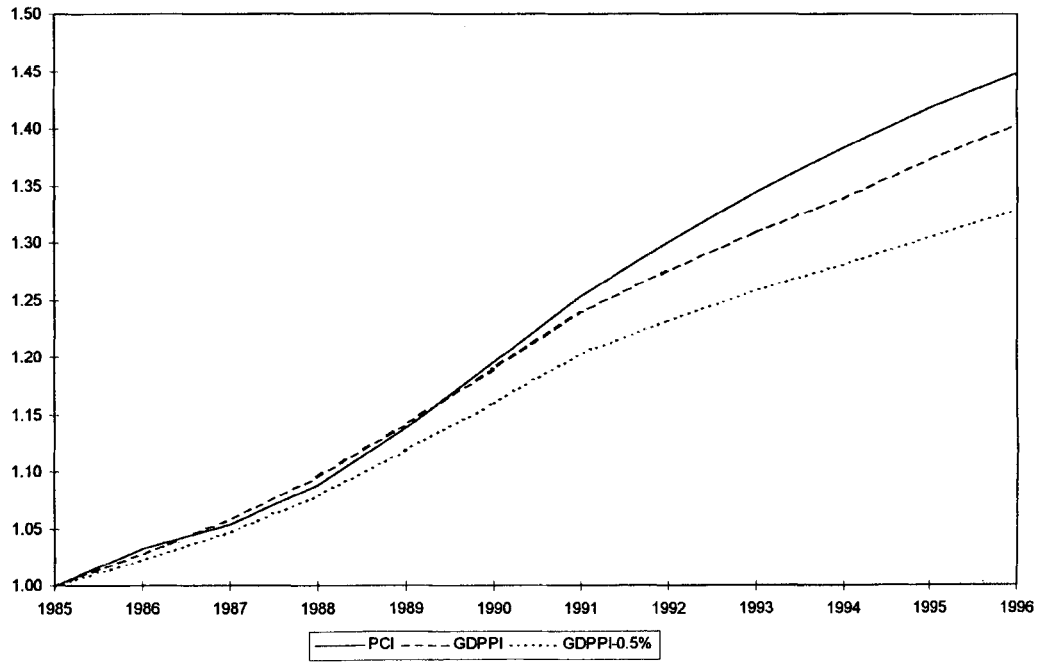

Table 1
Gains and Losses from Different Price Cap Formulas
Price Cap Plan Begins in 1985 and Runs through 1996
(millions of dollars)

	Price Cap Plan Based on:		
Year	PCI	GDPPI	GDPPI-0.5%
1986	622	517	369
1987	668	809	496
1988	(405)	(203)	(684)
1989	(742)	(662)	(1,364)
1990	275	67	(882)
1991	(546)	(975)	(2,143)
1992	(2,099)	(2,868)	(4,261)
1993	(660)	(1,865)	(3,635)
1994	1,097	(477)	(2,580)
1995	1,085	(555)	(2,961)
1996	678	(967)	(3,707)
1986-1996	(27)	(7,177)	(21,352)

Comments of John C. Panzar on H.R. 22 (Postal Reform Act of 1997)

Introduction and summary

The purpose of this testimony is to present my views on the strengths and weaknesses of the price cap regime proposed in H.R. 22. The views expressed are my own and do not necessarily reflect those of Northwestern University, the Law and Economics Consulting Group, or the United States Postal Service. Before getting into the details of the proposed price cap plan itself, it is important to have a clear idea of how the public interest might be served by a regulatory reform initiative of this type.

It is possible, but unlikely, that incentive regulation may transform the Postal Service into behaving like a profit-seeking entity. Given the Postal Service's current status as a public enterprise, the objectives pursued via the introduction of price caps or other forms of incentive regulation are fundamentally different than in the case of privately owned utilities. Those firms could be expected to act upon the efficiency incentives provided by price cap regulation because they provided a means of earning more profit for their shareholders. Such high-powered incentives are not present here, despite the Bill's provisions for profit-based bonuses. However, another characteristic of price cap regulation is enhanced pricing flexibility, and a move in that direction can be of immediate and significant benefit. Based on my experience with postal issues and discussions with Postal Service pricing and costing personnel, the primary motivating factor behind Postal Service pricing and costing decisions is quite simple to state: to support postal rates which maximize the Postal Service's ability to obtain (and retain) mail volumes for which it is the least cost provider. I believe this objective is in the Public Interest, and I believe that a move to appropriately designed price cap regulation can further this objective.

Thus my focus is somewhat different than most analysts of price cap regimes, who tend to focus on the role of price caps in providing incentives to reduce costs and improve productivity. The public enterprise nature of the Postal Service raises important questions about the applicability of this efficiency argument. Nonetheless, properly designed price cap regulation can help the Postal Service meet the competitive challenges which lie ahead.

Key attributes of any price cap regulatory scheme

There are many "necessary details" involved in any specific price cap proposal. While many seemingly "minor" provisions may turn out to be very important in practice, here I shall explicitly discuss only the general characteristics of the Bill's proposals and how they facilitate or inhibit the achievement of the objective discussed above. These key provisions include the construction of the cap itself through the design of the inflation index and adjustment (X) factor; the amount of pricing flexibility available to the firm under the cap; and the plan's treatment of new products and services.

The inflation index and the X factor

"No price cap plan can be any better than its X factor (and inflation index)." This statement, obvious but important, is especially relevant to the application of any price cap scheme to the Postal Service. If the X factor is too high, the firm is doomed regardless of the opportunities provided by an otherwise magnificent plan. The labor intensive nature of postal operations virtually ensures that any X factor combined with a general inflation type index such as the CPI or GDPPI must be negative. That is, it is unrealistic to expect labor intensive operations to achieve productivity increases as good as, let alone in excess of, the economy-wide growth in productivity. Of course a negative X factor would be politically difficult to build into the plan.

A potential solution to this dilemma is to use an index of labor costs. By determining the amount of the year to year increase in the cap using a labor cost index, this approach makes possible a non negative X factor as an incentive device. In order to understand the issues here, it is necessary to recall the basic tensions that must be balanced. One of the major objectives of price cap regulation is to "uncouple" the firm's rates from its costs. At one extreme, an index (such as the GDPPI) that is totally beyond the firm's control, accomplishes this goal. However, to the extent that the cost of the firms inputs increase at a substantially different rate, the ceiling so calculated can become increasingly irrelevant, with adverse effects for either the viability of the firm or the control of excessive profits. On the other hand, building into the index the level of inflation of the prices the firm actually pays for its productive inputs avoids this problem, but gives the firm no incentive to engage in "hard bargaining" with its suppliers. The use of economy-wide labor indices would seem to offer a good solution to this problem.

Labor arbitration issues

The binding labor arbitration process to which the Postal Service is subject places it in a unique position compared to other price cap regulated enterprises. It seems to me that the ability of price cap regulation to increase postal efficiency depends to a large degree on its impact on the arbitration process. This impact may, in turn, be determined by the form taken by the price cap index. For example, suppose that the arbitrator's wage decision does not depend upon postal profitability, productivity, etc. In that case, it would be an exogenous factor which could be used in calculating the index used to determine the postal price cap. This would solve, some of the problems posed by the labor intensive nature of postal operations by, in effect, "passing through" wage increases to mailers; albeit at the cost of reduced opportunities for cost reductions. However, would the arbitrator really ignore the pass-through nature of the price cap index, or would he or she view this as an opportunity to be "generous" to labor without undermining the viability of the firm?

Alternatively, suppose actual postal wage increase played no role in determining the postal rate cap. Would this cause the arbitrator to "think twice" before granting wage increases which might threaten the financial viability of the Postal Service? These are important questions which must be addressed.

Pricing flexibility

As I explained above, I view greater flexibility to meet competitive challenges as the principle benefit of a move toward price cap regulation. Unfortunately, H.R. 22 provides only part of the flexibility possible under price cap regulation.

Frequency of rate adjustment

The Bill limits rate adjustments to once per year. This is much too inflexible. The Postal Service should be free to re-adjust competitive/non dominant rates at any time. I see no reason to limit monopoly/dominant rate adjustments to once a year, but would not object strongly to this provision, especially if the Postal Service could lower those rates at any time. However, a great deal of the benefits of flexibility are lost if the rates of competitive services can also be adjusted only once a year. Similarly, the filing, notification, and other provisions which are applied to monopoly services should not be applied to competitive services. Indeed, such requirements tend to impede market competition, not to enhance it.

Service categories (baskets)

Price cap plans vary greatly in the amount of interservice pricing flexibility offered, from plans which cap each and every price to those which limit price increases only "on average." In practice, the distance from one extreme to the other is determined by the number of product categories, or baskets, provided for in the plan. If the number of baskets equals the number of products, there is no pricing flexibility. If there is only one

basket, only average prices are capped. The plan in the current version of H.R. 22 strikes me as having too many baskets, leaving the Postal Service with too little flexibility to raise some prices and lower others as market conditions might dictate.

Side conditions (bands)

Some mail services are more politically sensitive than others. The H.R. 22 proposal attempts to deal with this issue by introducing separate X factors to go with narrow baskets. In the absence of convincing evidence of significant differences in productivity improvements across baskets, I can think of no good economic reasons why more than one X factor should be used. It would seem to recreate opportunities for wasteful lobbying before the PRC by various groups of mailers seeking a relatively high X factor for the basket of services they purchase. Legitimate Public Interest concerns can be accommodated by means of side conditions (bands) placed on individual rates. The trick is to determine which types of bands make sense. For example, it might be quite reasonable to agree to a condition that the rate on First Class single piece letters would go up by no more than the CPI. On the other hand, a side condition that the rate on a particular type of bulk mail cannot be decreased in real terms should be unacceptable. One example of (what amount to) inappropriate side conditions are the provisions of the Bill [3772(a)] which seems to limit the rate increases on any individual product to no more than the overall maximum for the basket. If no rate can go up by more than the maximum, there is no room for any rate to go up by less than the maximum either. Thus, with a binding price cap constraint, interservice pricing flexibility would be eliminated by this provision.

Volume discounts

Enhancing the ability of the Postal Service to offer volume discounts is a primary attraction of price cap regulation. While there is no necessary connection between the two, volume discounts mesh very well with the spirit of price caps. Since volume discounts are

price decreases, their introduction into any otherwise lawful rate structure could not cause average rates to exceed their cap, and they should be presumed lawful, as long as the original rate remains available to small consumers. (There are antitrust issues that may arise if it can be demonstrated that volume discounts damage competition by favoring large businesses relative to their smaller competitors.)

Negotiated contract rates

The ability to negotiate contract rates with large mailers would greatly improve the competitive position of the Postal Service. While there is no necessary connection between this freedom and price cap regulation, one facilitates the other. One of the primary objections to negotiated rates under cost of service regulation is that the reduction in contribution of such favored large users must be made up by small users. Price cap regulation eliminates this concern. If the Postal Service can offer General Motors a negotiated rate under price cap regulation, it does so knowing that the terms of that agreement will not affect the rates it can charge to individual mailers. The only restriction on such contracts should be that they are remunerative: i.e., that they cover their incremental costs.

Price floors

Price floors are introduced into price cap plans to protect competitors, not consumers. Therefore, their only legitimate role is to ensure that the prices charged are not predatory. Without getting into detailed discussion of antitrust theory and practice, suffice it to say that any prices at least as large as average incremental costs cannot be predatory. The proposed Bill's provisions are seriously flawed in this regard. Its requirement of a price floor of attributable cost plus reasonable contribution is a recipe for disaster. In my experience, what the Postal Service terms "unit volume variable costs" are designed to approximate economic marginal costs. Thus unit volume variable costs, as calculated by

the Postal Service, without any added "reasonable contribution" should be the presumptive price floors for Competitive services. If such prices are expected to persist for a significant period of time, they should be examined to ensure that the entire incremental costs of the services in question are covered. (Any divergence between marginal costs and average incremental costs is likely to be small in practice.)

A statutory requirement that the price floors applied to Competitive Postal Service products contain a "reasonable contribution to all other costs of the Postal Service" is misguided and anticompetitive. It would set the stage for continued adversary proceedings over costing such as those that currently plague the PRC.

New products

Price cap regulation is particularly well suited to encourage the efficient introduction of new products and services. There are two primary reasons for this. First, as explained above, the separation of rates from costs eliminates any incentive to cross subsidize the new products with revenues from monopoly products. Second, the indices typically used in calculating price caps automatically facilitate the introduction of new products. The weights in these calculation of average prices are usually the quantities of the previous year. Thus, the price of a new product which had no sales the previous year does not count when determining the cap. The firm gets to keep the profits the first year. Consumers are not harmed if all other products remain available. Thus I enthusiastically support the Bill's provision for the Postal Service to undertake market tests of experimental products and services. However, I cannot comment on the appropriateness of the $100 million revenue limit for such tests.

Conclusion

The Postal Reform Act of 1997 contains many provisions which may prove useful in improving the efficiency of the nations postal and delivery networks, both public and private. I see these benefits coming primarily froma stream-lining of the rate-making process which will enable the Postal Service to successfully, but fairly, compete for those mail volumes that it can carry most efficiently. The Bill's provisions regarding volume discounts, negotiated rates, and new services are especially appealing in this regard. However, other provisions of the Bill such as narrow baskets, attributable cost price floors, and annual rate adjustments, limit the ability of the Postal Service to compete fairly and effectively.

Statement of William J. Baumol to the Committee on Government Reform and Oversight, House of Representatives, Congress of the United States, for its April 16 hearing on the Postal Reform Act of 1997.

Comments on the Price Cap Proposal for the U.S. Post Office: Promises and Avoidable Perils for the Public Interest

William J. Baumol

I am very grateful for the opportunity to present my analysis of the issues raised by the price cap proposal for the regulation of postage rates. First, to introduce myself, I should note that I am Director of the C.V. Starr Center for Applied Economics at New York University and professor emeritus at Princeton University. I have over three decades of experience on issues of rate regulation, having served as consultant to firms and regulatory agencies in the fields of railroading, telecommunications, electric power and postal services, among others. I have written a number of books and articles on the subject, including discussions of the price cap form of regulation, of which, it has been asserted, I may have been the inventor (in a 1968 article).

Hearings such as this are characterized by predictability of the contentions of the witnesses associated with the different interested parties. Thus, witnesses associated with competitors of the Postal Service can confidently be expected to advocate rules that impede reductions in the rates charged by the Postal Service, while witnesses from commercial mailer groups can be relied upon to take the other side. It is therefore important that I make clear my association with the U.S. Postal Service, for which I have from time to time served as consultant, since this association may conceivably have colored my views. However, I think that the observations that follow are dispassionate and are intended to serve no vested interests other than what I believe to be the public interest.

Given the fact that immunity from competition for the Postal Service grows increasingly elusive, even if it were considered desirable, the necessity of increased flexibility in decision making, with decreased delay in adaptation to rapidly evolving market conditions, grows ever more imperative. This is called for not only by the needs of the Service itself, that is, by the requirements for its continuing viability, but even more urgently by the public interest, which will be served poorly by ill-conceived restrictions that impede the workings of the organization and hamper its efficiency in serving the public's requirements.

The proposed changeover in postal regulation from the current arrangement to a price cap regime constitutes an opportunity to obtain the requisite increase in flexibility. In addition, price caps promise to provide some incentive for increases in efficiency, with savings for customers and rewards for good performance to Postal Service personnel. Though the price-cap mechanism was designed for the circumstances of a privately-owned, profit-seeking firm that is regulated to

prevent the exercise of market power, it is possible in principle to adapt the arrangement to the situation of an enterprise such as the Postal Service. Thus, though the price cap approach will probably match the needs of postal regulation rather imperfectly, the approach has considerable attraction in terms of its prospective contribution to the public interest.

The matter is made urgent by the growing threat from electronic competition and rivalry from other sources. By the very nature of price caps, they should bring with them a considerable increase in freedom of decision making such as is now needed.

Nevertheless, there is substantial danger that a price-cap arrangement, improperly designed, can cause more harm than benefit to the public interest and that of the Postal Service. In what follows, I discuss the pertinent issues in turn, describing what my experience on the subject suggests should be done and what must be avoided.

I. Non Profit-Seeking Enterprise and the Incentives Provided by Price Caps

Price caps provide efficiency incentives by automatically increasing the profits of the regulated enterprise that succeeds in reducing its costs rapidly or in enhancing its sales volume through improvement in product quality. The obvious difficulty impeding use of this device in regulation of an organization such as the Postal Service is that the Service is not a profit-seeking firm. It is true that, if the price caps work as they should, through the resulting increase in efficiency the Service is likely to earn a surplus or reduce the prospect of a deficit, but who in the Service will treat this alone as an incentive for enhanced effort?

Such incentives can be offered by the legislation so long as it adopts a suitable provision for division of any surplus. Specifically, there are (at least) five possible uses to which any surplus can be put: 1) incentive payments to management, 2) incentive payments to other employees, 3) debt reduction, 4) investment in plant and equipment to improve quality of service and 5) payment to the Federal Government. It is clear that such a system of payments can provide effective incentives, however imperfectly. It seems desirable that this be built into the legislation, with proportions among the five types of `payment built into the rules in advance to prevent undermining by inappropriate regulatory intervention. It would be desirable for the legislation to determine the five target percentage figures for the apportionment of any surplus, with management given a range of discretion (say 5 percent deviation from the legislated figure) for any payment except that going to itself.

II. Determination of the Price-Cap Parameters: The Price Index and the X adjustment

As is recognized by the framers of the proposed legislation, price caps are constituted by an automatically adjusted ceiling that constrains an average of the prices of some set of the services supplied by the regulated firm. The ceiling is adjusted automatically at preselected intervals. First, it is increased proportionately by some preselected measure of inflation in order to permit the regulated firm to make up for cost increases that are beyond its control and are attributable to inflation. Then that adjusted figure is readjusted by deduction of some percentage figure from the rate of inflation. That deduction number, often called "the X factor" is meant to correspond to past productivity growth in the industry, and is used to provide an incentive for the enterprise to do whatever it can to keep cost increases to a minimum by raising efficiency and productivity. Under this arrangement if the firm can cut its costs more than X percent in a year it

will be able to earn correspondingly higher profits as its reward. On the other hand, if its cost saving does not match the X percent target, the price ceiling, having been cut by X percent below the rate of inflation, will automatically penalize the enterprise financially by a similar amount. This, in brief, is the incentive structure built into the price cap mechanism and experience elsewhere indicates that it can be very effective.

In telecommunications and other regulated arenas there has been a propensity to base the price-cap calculations on some widely-known price index such as the CPI. Use of such an index, however, poses an enormous peril for the Postal Service. Different sectors of the economy manifest persistent differences in their productivity growth rates. Services whose technology imposes a substantial handicraft component upon their supply process -- a component very difficult to mechanize or automate -- understandably having the record of slowest productivity increase. There is little prospect that any postal system, with its substantial handicraft component, such as house-to-house delivery of mail, that is not easily reducible, will ever be able to achieve productivity growth comparable to that in a service such as telecommunications with its predominantly electronic and automated technology. The result is that postal costs are forced to rise persistently and substantially more quickly than those of telecommunications. Unless the design of a price cap for the Postal Service is adapted to this inescapable difference, the Service is likely to find itself saddled with substantial and increasing financial difficulties that can only undermine viability of the service and cause deterioration in service quality.

The appropriate way to deal with this seems to be adoption of a carefully tailored price index and an appropriate formula for the calculation of the X deduction that takes this difficulty into account. A postal service inflation index that is an average of the service's cost components, with a relatively large weight assigned to labor cost, is a very promising approach to the matter. However, it should be recognized that even then for the Postal Service an X deduction very close to zero may be unavoidable. This is so because the handicraft nature of much of the activity of the service can prevent any substantial and cumulative productivity gains.

In any event, before any particular price index or any particular procedure for calculation of X is finally adopted it is essential that the formula be subjected to extensive and careful testing with the aid of past data, to determine what consequences the formula under consideration would have had if it had been used earlier, and what dangers it poses for the future.

III. Built-in Pricing Flexibility to Avoid Undermining of the Price Cap

Experience indicates that there are several ways in which the appearance of a price-cap arrangement can be maintained while its substance is gutted. One very important issue here is the pricing flexibility and speed of adaptability to evolving market conditions that a price-cap arrangement promises. Obviously, prices adopted by management should not be permitted to violate the price-cap ceiling or fall below the appropriate incremental cost floor. However, if every modification of a price proposed by management must be accompanied by full calculation

and documentation of the relevant costs [1]and subject to challenge and extensive hearings before it can go into effect, the flexibility promised by the price caps will be nullified.

It is therefore essential that the legislation explicitly provide that any proposed price change be presumed legal and go into effect without delay. It should, of course, be subject to challenge, but the burden of proof should be borne by the challenger (who should, however, be given access to the required Postal-Service data upon showing by the challenger that there is some substantial prior evidence for its claims). Those damaged by prices found to be illegal upon later challenge should of course be eligible for ex post compensation for the damage sustained. But such an arrangement does not curtail price-setting flexibility or speed of action by regulated firms. Instead, it subjects them only to the sort of oversight that applies to unregulated firms.

IV. Preset Review Periods and Preclusion of Undermining of the Price Caps

Elsewhere, price caps have at least sometimes led to profound improvements in service quality and great reductions in costs, bringing substantial profits to the regulated firms as the reward for their exemplary performance. The rules for these price caps called for continuation of such profit opportunities for a specified inter-review period, typically four or five years. But in a number of previous cases, regulators, seeing the high profits earned by the firms as a result of exemplary efficiency performance, in effect have chosen to abrogate the price-cap compact, unilaterally reducing the price ceilings (usually through severe increases in the X figure) one or two years into the inter-review period. Such regulatory action in effect abandons the price cap for a traditional ceiling on the earnings of the regulated firm, thereby undermining the incentives for increased efficiency growth in the future and destroying any trust in future commitments by the regulator.

To avoid this very common peril, it is essential that the length of the inter-review period be set in the legislation, and that the regulatory agency be given no discretion over it.

IV. Size of the Baskets

It is desirable for price-capping purposes that postal services be grouped into several large baskets, each basket (except the competitive basket) subject to its own overall price ceiling, that is, to a ceiling on the average price of the services it contains. Experience indicates that the basket approach is essential to provide the requisite pricing flexibility. I myself am inclined to favor three baskets: the competitive basket in which control of prices is left to market forces with only occasional regulatory review, the basket of monopoly services, and the transition basket including services facing growing competition, but for which the competition is deemed insufficient for complete and immediate deregulation.

V. Introduction of New Services

It is also essential that the legislation avoid any impediments to the introduction of new

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[1]Generally the appropriate cost figures are the supplier's incremental or marginal costs, for reasons indicated by standard economic analysis.

services. Any new service introduced without elimination of another service should be left free from any price-cap ceiling for some predetermined period, say three years, and then assigned to one of the three baskets on the basis of evidence on the strength of the competition it faces.

Even where services are introduced as substitutes for others that are then discontinued, launching of the new service should not be impeded or delayed. If the earlier substitute service is discontinued, the new service should simply be subjected to the same regulatory constraints that faced its predecessor.

VI. Oversight Over Quality

It may be thought that a price-cap arrangement's incentive for cost reduction also tempts the regulated firm to skimp on product quality. However, this is a misunderstanding. Price caps yield a substantial surplus to the regulated enterprise only if the product is sufficiently attractive to customers to bring in a large volume of sales. In principle, price caps should be as effective as the unregulated competitive market in providing appropriate rewards for product quality. Indeed, by providing larger funds for improved plant and equipment, price caps may even further enhance service quality.

I therefore recommend that regulators continue to monitor product quality, but that no special quality rules or incentives be built into the legislation unless experience proves them necessary.

VII. Transition Arrangements

It is not clear to me whether it is preferable to continue with current prices as the basis for inauguration of a price-cap arrangement or whether a large scale set of rate hearings promises a more appropriate starting point.

On the other hand, I do recommend a review of the performance of the initial price cap rules and arrangements after some suitable interval, say, two years. It is very likely that some of the ex ante decisions will prove to be mistakes, and any egregious errors should be corrected by the regulatory agency at this initial review. It should not entail any fine tuning or changes in the underlying price-cap arrangements, but may call for changes such as revision of the price-index formula or the data it utilizes.

IX. Concluding Comment

The proposed legislation should clearly be viewed as a very promising opportunity for the Postal Service to adapt itself to the prospect of growing competition, to improve its financial position and to serve the public better. Yet the perils of a poorly designed price cap are enormous and great effort may be required to avoid the pitfalls. The issues discussed here must be thought through carefully because they raise the possibility of serious impediments to the health of the postal system and the welfare of the general public.

LAW DEPARTMENT
UNITED STATES
POSTAL SERVICE

FAX TRANSMISSION COVER PAGE

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DATE: April 7, 1997 **TIME:** 4:26pm

TO: Will Baumol

Telephone: 212-998-8943
Destination FAX No.: 212-995-3932

FROM: Richard T. Cooper
Law Department

Telephone: (202) 268-2993

FAX No.: (202) 268-5402 or (202) 268-6187

Number of Pages: 7 (Excluding Cover Page)

Message: Will: As I read the subcommittee's request, you are to report the source and amount of any federal contract recieved by you or any entity you represent at the hearing, for the previous fiscal year (which in this case would be FY 1996), and a separate amount for work specifically on postal matters. My investigation reveals that in FY 96 the Postal Service paid you no money under your contract. However, should you care to report it, we paid you $11,851.00 so far in FY 1997, and there are outstanding invoices in the amounts of $8,888.00 and $8,887.00. All payments were for postal matters. See enclosed copies.

Please call to confirm receipt, or if you have any questions. Rick

475 L'ENFANT PLAZA SW

Dr. William Baumol

Paid Invoices

Invoice 1: $8,888.00

Invoice 2: $2,963.00

Both paid on 11/8/96. Check No. 07206242 in the amount of $11,851.00. Cashed on 1/7/97.

Outstanding invoices

Invoice 3: $8,888.00

Invoice 4: $8,887.00

From Professor S C Littlechild
Director General of Electricity Supply

The Rt Hon John M McHugh
Chairman
Subcommittee on the Postal Service
Congress of the United States
Committee on Government Reform and Oversight
2157 Rayburn House Office Building
Washington DC 20515-6147

7 April 1997

Dear Mr. McHugh

Thank you for your letter of March 21 inviting me to testify at the hearing on price cap regulation to be held by the subcommittee on the Postal Service on April 16. Unfortunately, with the recent announcement of a General Election in Britain, the standard guidelines indicate that I should withdraw from making such public appearances during the election period. I therefore regret that I must decline your invitation.

You may find it helpful to see a copy of the evidence that I gave very recently to the Trade and Industry Committee of the House of Commons on the question of price cap regulation, together with the Committee's conclusions earlier this month. You will see that the Committee recommended that the use of RPI-1 incentive regulation should continue, and that regulators should continue to use RPI as a measure of inflation in the price control formula. I hope this is helpful to you.

Yours sincerely
Stephen Littlechild

PROFESSOR S C LITTLECHILD
Director General of Electricity Supply

HOUSE OF COMMONS SESSION 1996–97

TRADE AND INDUSTRY COMMITTEE

ENERGY REGULATION

(EXTRACT OF EVIDENCE FROM DGES P276-277)

MINUTES OF EVIDENCE

Wednesday 22 January 1997

OFFICE OF ELECTRICITY REGULATION (OFFER)
Professor Stephen Littlechild, Mr Peter Carter and Mr Tony Boorman

BRITISH GAS PLC
Mr David Varney and Mr Mike Alexander

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The third case concerns NGC's proposal to construct new high voltage transmission lines from Teesside through the Vale of York. A protest group has fought the proposal at Public Inquiries, and has also requested the DGES to intervene on the ground that the National Grid Company is in breach of the Electricity Act and of its transmission licence in making these proposals. The DGES has investigated the complaint and published his findings that NGC is not in breach of the Act or its licence. The pressure group has sought judicial review of some of those findings. The matter will be heard by the Court in due course.

There is further protection with respect to what, in this context, are the most important set of decisions, namely to propose changes to the licence. The DGES does not have power to dictate any change to electricity licences. Section 11 of the Electricity Act makes provision for licences issued under the Act to be amended on a proposal by the DGES with the agreement of the licensee. If the licensee does not accept the DGES's proposed amendments, however, the DGES—if he still wishes to proceed with the amendments—may make a reference under Section 12 to the MMC. The MMC is required to specify in its report any effects adverse to the public interest in the matters which the DGES has referred to it, and any licence modifications which they consider could remedy or prevent those effects. If the MMC report concludes that any of the matters specified in the reference operate, or may be expected to operate, against the public interest; and they specify the adverse effects, and licence modifications by which the adverse effects could be remedied or prevented; then the DGES is required to make such licence modifications as appear to him requisite for the purpose of remedying or preventing those adverse effects. In doing so, he is required to have regard to the licence modifications specified by the MMC in their report.

The effect of these provisions of the Act is to give a licensee who does not accept proposals by the DGES for licence modifications the ability to argue its case to the MMC ie effectively a right of appeal. For example, in October 1994 Scottish Hydro-Electric rejected proposed amendments to the provisions of its licence containing price controls on its distribution and supply businesses. The DGES thereupon made a licence modification reference to the MMC, and Scottish Hydro-Electric was able to present its arguments in detail to the MMC in the course of the investigation.

The Electricity Act also contains protection for other parties who may be affected by licence modifications which the DGES proposes to make. Section 11(2) requires the DGES to advertise proposed licence modifications before they are made; and to consider any representations or objections made to him. It is incumbent upon him to reconsider his proposals in the light of these representations or objections, and where appropriate to modify his proposals, as he did in the case of his proposed changes to the price controls on the distribution businesses of the RECs. Section 11(4) gives the Secretary of State a power to direct the DGES not to proceed with a proposed licence amendment. He has not yet used this power, but it would be open to him to consider doing so in response, for example, to representations by parties who might be affected by the proposed changes.

Q7. *How effective has the RPI-X mechanism been in achieving its objectives? What are the main advantages and disadvantages of RPI-X compared with other methods of price control?*

In broad terms, RPI-X price controls fix the level and path of average prices which the company may charge during the period of the price control. They are typically set on the basis of an analysis of the costs which the company will need to incur, including both operating and capital costs, and the need to make a return to shareholders. To the extent that companies are able to reduce costs below the levels assumed when the price control was set, they are able, for the period of the price control, to retain the benefit. RPI-X price controls therefore give incentives to the companies to improve their efficiency and reduce their costs.

Under RPI-X controls, the benefits from improved efficiency are passed on to customers in two ways. First, when the regulator reviews the control, he sets a new control taking account of efficiencies already achieved, and thereby passing the future benefits from these efficiencies to customers. Second, where justified, the control will be based on an assumption that costs can be further reduced during the period of the control. The prospective benefits of this will therefore be built in to the prices charged under the control. It has been calculated that, under RPI-X controls, some 70 to 90 per cent of the value of cost reductions ultimately accrue to customers.

RPI-X price controls require the regulator to take a view about the future level of costs which an efficient company might incur. It is possible that, in the event, a company might have higher or lower costs than the regulator had assumed, and that it will incur losses or realise profits which are different from those anticipated when the control was set.

In the electricity industry, RPI-X price controls have been successful both in promoting efficiency and in passing the benefits of these efficiencies on to customers in the form of lower prices. For example, the transmission business of the National Grid Company (NGC) cut operating costs by approximately 28 per cent in real terms between 1990–91 and 1994–95. In distribution, the RECs on average have cut operating costs by approximately 11 per cent in real terms over the same period.

The DGES has reviewed all of the price controls on the electricity companies. With a single exception (the price control on the transmission business of ScottishPower), he has been able to tighten and control, taking account of, among other things, both the efficiency gains which the companies had made and those which they might be expected to make in the new control period. For example, in his reviews of the distribution price controls of the RECs, he proposed real price reductions of between 20 and 30 per cent over the first two years of the new control, followed by an RPI-3 control for a further three years. In his recently published proposals for a new price control on the transmission business of NGC, he has proposed a real price reduction of 20 per cent in 1997, followed by RPI-4 for the following three years.

An alternative approach to price control which has been used in the United States is one which effectively obliges the company to set and revise its prices so as to achieve no more than a specified rate of return on its assets. Problems with this approach include the reduced incentive to improve efficiency, the problems of specifying how a rate of return to be calculated and of monitoring this rate of return, and the uncertainty as to when the regulatory body (or the company) will initiate another rate review.

A sliding scale price control has been suggested as an alternative to either RPI-X or to rate of return regulation. There are many possible versions of this. A level and course of prices might be set for a number of years ahead, as with an RPI-X control. The company would have to reduce its prices further if its profits rose above a certain level or would be able to raise prices if its profits fell below a specified level.

A sliding scale control would be likely to reduce the incentives on the company to improve efficiency, and may therefore be less effective than an RPI-X control in securing cost reductions and lower prices for customers. A sliding scale control would also be likely to pose significant problems as to how "profit" was to be defined, and would give companies incentives to manipulate profit so as to minimise or eliminate any requirement to reduce prices to customers. In the DGES's view, RPI-X controls have significant advantages over the alternatives as a means of regulating the core monopoly activities of electricity transmission and distribution. There is a case for considering alternatives akin to a sliding scale control in certain circumstances. He has, for example, proposed a form of a sliding scale control on NGC's revenue from transmission services.

Q8. *Who do you consider yourself accountable to and how do you consult and inform relevant parties? Could accountability and transparency be increased, for example through wider use of public hearings or more detailed explanations of decisions?*

The Act provides for the independence of the DGES, in that it gives him specified responsibilities, functions and duties which he alone has to consider how to discharge and for which he alone is held responsible (see answer to Q1 above). The legislation relating to Regulators of other utilities makes very similar provision. The Regulators are nonetheless accountable in a variety of ways to a number of different persons and bodies.

The DGES is accountable to the Secretary of State, who appoints him for a maximum period of five years and may remove him on grounds of incapacity or misbehaviour. He is required under Section 50 of the Electricity Act to prepare a report on his activities for the Secretary of State, which the Secretary of State is then required to lay before Parliament. The DGES' ability to grant licences is dependent on a general authority issued by the Secretary of State. As noted in the answer to Question 1 above, the DGES' exercise of certain of his more important powers under the Electricity Act, including his power to make licence modifications or a licence modification reference to the MMC, are subject to veto by the Secretary of State.

The DGES is accountable to Parliament, in that he may be called upon to give evidence to and appear before Select Committees. To date he has made five appearances before Select Committees, and has given written evidence on a number of other occasions. Following a report of a Select Committee, he replies to those recommendations in the report which are addressed to him.

The DGES's office is funded out of money provided by Parliament; the costs are recovered from the electricity companies via licence fees. As the Accounting Officer he is held responsible for OFFER's expenditure in the same way as the Accounting Officer of other departments. He is subject to scrutiny by the Comptroller and Auditor General, and also by the Parliamentary Commissioner for Administration. The Comptroller and Auditor General has recently published a report on the activities of four of the Regulators including the DGES; and the Public Accounts Committee has asked those Regulators to appear before it.

The DGES is accountable to the Courts, through the process of Judicial Review, as regards the proper and lawful exercise of his powers. As noted in the answer to Q6 above, this process is an active one.

The DGES is accountable in a more general sense to those who might be affected by his decisions. For example, as noted above, the provisions of the Electricity Act require him to publish proposals and invite representations, and to consider any representations or objections which are made to him, before making licence modifications and when exercising his enforcement powers.

It has been the DGES's policy to consult widely on the main issues which fall within his responsibilities, and to do so in advance of any formal consultation period required under the Act. In most cases, he issues consultation papers, which explain the background to the issues involved, the main questions on which he

HOUSE OF COMMONS SESSION 1996–97

(EXTRACT FROM CONCLUSIONS)

TRADE AND INDUSTRY COMMITTEE

First Report

ENERGY REGULATION

Report, together with the
Proceedings of the Committee

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the introduction of competition. OFFER told us that "The Director General of Electricity Supply where this is feasible considers that customers are more effectively protected by competition than they are by regulation";[43] and Ms Spottiswoode said that since she had come to OFGAS she had concluded that "competition is far and away the best way of helping customers, both through standards of service and price".[44]

33. The official energy consumers' representative groups shared the regulators' optimism about competition as a means to benefiting the consumer, although not regarding it as an end in itself.[45] They were aware, as were the regulators, of the problems of vulnerable consumers (see paras 142-145), but felt that properly implemented (which would include, in the case of electricity, reform of the Pool),[46] competition would benefit even these in the long run.[47]

Price Controls

34. One objective of regulation was to establish mechanisms to prevent the utilities from exploiting their dominant market power given that they face, initially at least little, or no effective competition, while at the same time providing incentives to improve efficiency. The aim was to achieve a balance, ensuring that the utilities were able to carry out their functions effectively and profitably, and protecting the interests of consumers in terms of prices and quality. To achieve this, the Government chose to impose price controls, rather than methods such as an annual rate of return requirement which would control profits, and adopted a formula based on the RPI-X principle.[48] Although not obliged by law to continue with this form of regulation, all utility regulators in the UK have so far decided to do so. The two energy regulators told us that they believe that it protects consumers from the abuse of monopoly power and benefits consumers through greater efficiencies, while encouraging companies further to increase efficiency.[49]

35. The RPI-X price cap operates by restricting the annual price changes to the rate of change of RPI minus or plus a fixed factor X. In addition there may also be controls on total allowed revenue. The X is intended to represent an efficiency factor, and is based on the cost structure of the company. However, there are also provisions for the pass through of certain costs deemed to be outside the control of the company, for example, environmental levies. Hence, consumer end prices do not necessarily rise or fall in line with RPI-X. There are also provisions for including forecasts in relation to raising capital expenditure for the purposes of improving quality standards. Table I below shows the different price controls set and proposed for gas and electricity supply, distribution and transmission charges since privatisation. In the gas sector, British Gas prices to consumers who use under 2,500 therms a year (the monopoly element in gas supply), are currently capped by an X factor of 4; in the gas transportation and storage sector, the maximum average price which TransCo is allowed to charge users of its facilities is capped by RPI-5.[50] In the electricity sector, the price control formula applied to transmission is currently RPI-3 (OFFER has agreed [hence changes] to cut transmission prices by 20% in 1997 and set X at 4 from 1998 to 2001; distribution charges have been cut by 13% in 1996-1997 and X will be set at RPI-3 from 1997 until 2000).[51]

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[43]Ev. p.273.

[44]Q.866.

[45]Q.379.

[46]Q.482.

[47]QQ.380, 487.

[48]Ev. p.324.

[49]Ev. pp.276, 247.

[50]OFGAS, *Annual Report 1995*, pp.16-17.

[51]OFFER, *Annual Report 1995*, p.8; It should be noted that where the controls (wholly or partly) cap revenue as well as prices, then the outturn maximum allowed price may be different from the regulators' forecast price caps, shown in the table. In practice, the presentation of price cap controls by regulators may also have included reference to cuts in the base tariff (ie P_0), for example, in the electricity distribution review for the year 1995/6, the price controls were calculated as a set of P_0 cuts plus RPI-2 for that year.

Table I: Main Price Caps for Gas and Electricity since Privatisation

British Gas Trading (supply)	
December 1986-March 1992	RPI-2+Y
April 1992-March 1997	RPI-5+GPI-Z+E
Redetermined January 1994	RPI-4+GPI-Z+E
Where CPI=Gas Price Index; Z=1% pa; E=Energy Efficiency schemes; Y=Gas purchase costs)	
April 1997-March 2000	RPI-4+Y
BG plc (TransCo)	
October 1994-March 1997	RPI-5
(Where the average price per therm in the base year, 1993-94, is 14.16p.)	
April 1997-March 2002 (proposed)	RPI-20 (1997)*
Equates to -6.5% p.a. for full five years	RPI-2.5 (1998-2002)*
Electricity Supply	
April 1990-March 1994 (England and Wales)	RPI-0+Y
April 1994-March 1998 (England and Wales)	RPI-2+Y
April 1990-March 1995 (Scotland)	RPI-0+Y (Hydro) RPI-0.3+Y (ScottishPower)
April 1995-March 1998 (Scotland)	RPI-2+Y
April 1992-March 1997 (Northern Ireland)	RPI+0+Y
April 1997-March 2001 (proposed)	RPI-43.9+Y (1997)*
	RPI-1.5+Y (1998-2001)*
(Y covers pass through of distribution, transmission and generation costs. Note: the temporary cap on generation prices in England and Wales ended in 1996.)	
Distribution (England and Wales)	
April 1990-March 1995	RPI+0.0 to +2.5 (av.+1.3)
April 1995-March 1996†	RPI-11; -14 or -17 (av. -14)
April 1996-March 1997†	RPI-10; -11 or -14 (av. -11.5)
April 1997-March 2000†	RPI-3
(†Equivalent to an average reduction in X from +1.3% p.a. to -9.5% p.a. for the full five years. The caps were redetermined from April 1996 from RPI-2.)	
Distribution (Scotland)	
April 1990-March 1995	RPI-0.3 (Hydro) RPI-0.5 (ScottishPower)
April 1995-March 2000	RPI-1 (Hydro) RPI-2 (ScottishPower)
Transmission	
April 1990-March 1993 (NGC)	RPI-0
April 1993-March 1997 (NGC)	RPI-3
April 1997-March 2001 (NGC)	RPI-20 (1997) RPI-4 (1998-2001)
April 1990-March 1994 (Scotland)	RPI-0.5 (Hydro) RPI-1 (ScottishPower)

April 1994-March 1999 (Scotland)	RPI-1.5 (Hydro) RPI-1 (ScottishPower)
Northern Ireland Electricity (transmission and distribution)	
April 1992-March 1997	
Fixed component (75%)	RPI+3.5
Variable component (25%)	RPI+1.0
April 1997-March 2002 (proposed)	RPI-30 (1997)* RPI-2 (1998-2002)*

Source: Centre for the study of Regulated Industries; also in Public Services Yearbook 1997-98 (forthcoming).
* Proposal referred to MMC.

36. Both electricity and gas prices to customers have fallen since privatisation. Electricity prices (before VAT) to domestic customers have fallen by 15% in real terms, and industrial electricity prices to moderately large users fell by about 21% in real terms.[52] In 1995 industrial electricity and gas prices in real terms were at their lowest since records began in 1970. However, not all of this fall in prices is directly attributable to the price controls. ESTUC argued that "the fall in electricity prices since 1992 owes more to favourable circumstances in the market for generation fuels than to greater competition in supply".[53] The DGES stated that primary fuel prices, including the prices of coal and gas used by generators, have fallen since 1990/91, and that "the impact of such reductions on prices cannot, however, be considered independently of the introduction of competition in the generation market".[54] He estimated that of the 15% fall in electricity prices in real terms to domestic customers since 1990/91, "about 5% is the result of the operation of price controls on distribution, transmission and supply charges. About 6% arises from reductions in the purchase cost of generation which the RECs are permitted to pass through to franchise customers under the supply price control. The remaining 4% is the result of reductions in the fossil fuel levy".[55] Of the 21% fall in industrial prices, "just over 3% ... can be attributed to the operation of price controls on distribution and transmission charges, about 13% to reductions in generation prices, and 5% to reductions in the levy" [56]

37. The price of gas to domestic customers has fallen by 24% in real terms since privatisation,[57] while prices to commercial and industrial gas customers have fallen by 59% in real terms. In 1995, the latest year for which data are available, UK industrial gas prices were the lowest in the European Union.[58] Table II below shows the extent to which the fall in prices to consumers is associated with reduced wholesale gas prices and to what extent it is the result of lower transportation, storage and supply costs.

Table II: British Gas Customers consuming at or below 2,500 therms of Gas a year (real 1996 prices)

	1987 p/therm	1996 p/therm	% reduction
Gas Costs	22.25	20.21	19.96
Other Costs[1]	38.94	28.52	26.76
TOTAL	64.19	48.73	24

[1] transportation, storage, supply Source: Ev. p.288.

[52] Ev. p.300.
[53] Mem. p.88.
[54] Ev. p.300.
[55] *Ibid.*
[56] *Ibid.*
[57] Ev. p.251.
[58] HC Deb (1996-97) c.1095 w.

OFGAS told us that the substantial reduction of prices to [industrial] customers was largely associated with lower wholesale costs, and that "much of the real price reduction to smaller customers who are still protected by price controls is the result of direct regulatory intervention".[59] The broad reductions referred to by OFGAS were confirmed by the DTI, who stated that "around two-thirds of the fall in real consumer prices ... was due to the fall in beach prices, with around one-third attributable to the price cap on non-gas costs" and that, during 1992 to 1996, "when beach prices have fallen less sharply and have been subject to a separate capping arrangement, the contribution to the fall in final gas prices (excluding VAT) of the gas cost element in the formula and the non-gas cost element have been similar" (see Table III).[60] (A more detailed examination appears in paras 182-188).

Table III: Movements in Gas Costs since 1980/81

(a) Movement in gas prices in cash terms

	a	b	c	d	e	f	% change		
	1980/1	1985/6	1986/7	1991/2	1992	1996	b/a	d/c	f/e
RPI gas (Excluding VAT)	49.4	89.18	90.3	107.8	107	113 104	80.5	19.4	5.5 -2.2
Non-gas cost p/kWh (Excluding VAT)	0.51	0.76	0.84	1.05	1.10	1.20 1.06	48.1	25.0	9.0 -3.0
Beach-gas cost p/kWh	0.282	0.675	0.61	0.66	0.60	0.59	139.4	8.2	-0.8
Total gas cost p/kWh (Excluding VAT)	0.79	1.43	1.45	1.71	1.69	1.79 1.65	80.5	17.9	5.5 -2.2

(b) Movement in gas prices in real terms

	a	b	c	d	e	f	% change		
	1980/1	1985/6	1986/7	1991/2	1992	1996	b/a	d/c	f/e
RPI gas (Excluding VAT)	87.1	115.4	113.4	99.8	95.8	91.4 84.6	32.5	-12.0	-4.6 -11.7
Non-gas cost p/kWh (Excluding VAT)	0.90	0.98	1.06	0.99	1.01	1.00 0.89	9.4	-6.6	-1.0 -11.9
Beach-gas cost p/kWh	0.5	0.87	0.76	0.61	0.53	0.47	74.0	-19.7	-11.3
Total gas cost p/kWh (Excluding VAT)	1.40	1.85	1.82	1.60	1.54	1.47 1.36	32.5	-12.1	-4.6 -11.7

Note: Base year = 1990
Source: Ev. p.341.

38. The Trades Union Congress and ESTUC argued that part of the productivity gains have also been due to reductions in employment costs. ESTUC told us that since 1989/90 employment in the RECs has fallen by 38%.[61] Overall, in the electricity industry, "there have been job losses of 50% in generation, 30% in transmission, and 16% in distribution".[62]

[59] Ev. p.269.
[60] Ev. p.341.
[61] Mem. p.90.
[62] Mem. p.113.

The DGGS said that "British Gas has achieved substantial gains in labour productivity".[63] During the period 1990 to 1995 there was a 43.6% fall in the number of employees.[64] Job losses in electricity and gas industries since privatisation total some 45,000 (Company Reports HOC Library). We have not attempted to quantify the fraction of the job losses which relate to the productivity gains or to the savings passed on to the consumer by way of price reductions but against any benefit or lower prices, there is an offset for the cost to the nation of the related unemployment.

39. While many of the savings made in both the gas and electricity industries cannot be directly attributed to the operation of price controls or regulation, there is no guarantee that these savings would have been identified or passed on to the consumer if it had not been for the competitive environment created by privatisation.

Why incentive regulation?

40. Several witnesses contrasted the RPI-X form of incentive regulation with the 'rate of return' method adopted in the US, which is based on controlling the profits of regulated companies. A particular advantage of the rate of return system is that it reduces the possible extremes of profit or loss. However, a system which permits the firms to earn no more than the specified rate of return each year does not give the company strong incentives to reduce costs because the company will receive no benefits from efficiency improvements.[65] In fact, as we found when we visited the United States, there is an incentive to undertake expessive capital expenditure in order to expand the asset base on which the rate of return is to be earned (a process known as 'gold-plating'). This is regarded as the major drawback of the rate of return system. The DTI and the energy regulators argue that this system would also require more regulatory intervention, for example, the rate of return would have to be monitored closely.[66] Mr Eggar described rate of return regulation as "too cumbersome, costly and legalistic".[67] He also pointed out that most countries introducing regulatory systems "are adopting the United Kingdom system of price control rather than the United States system."[68]

41. Several witnesses, including the Energy Advisory Panel and Midland Electricity plc, regarded the RPI-X form of incentive regulation as superior to rate of return regulation because it gives management a direct financial incentive to become more efficient, as well as allowing control over the level of prices charged to consumers.[69] If the company can increase efficiency by an amount greater than that allowed for by the regulator it can retain the additional profits (economic profit), for the period of the price cap.[70] This provides powerful incentives to reduce costs. Conversely, if efficiency improvements are less than expected, profits are reduced. In addition, the price caps are reviewed periodically in order to achieve an equitable balance between additional returns to the shareholders from that improved efficiency, which maintains incentives for the future, and the passing on of the further improvement to consumers, either by a one-off cut in prices in the year following the review, or by a tighter annual value for X (i.e. a lower price to customers from the date of the periodic review).[71]

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[63] Ev. p.247.

[64] Report by the Comptroller and Auditor General on *The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply*, 1996, p.179.

[65] Ev. p.247; Mem. p.29.

[66] Ev. pp.248, 277, 324.

[67] Ev. p.71.

[68] Q.311.

[69] Mem. p.117; Ev. p.324; Mem. pp.31-2; Ev. pp.276-7; Mem. p.51.

[70] Mem. p.116.

[71] Ev. pp.276-7.

Criticisms of the RPI-X form of regulation

42. Criticisms of RPI-X regulation have centred around the implementation and operation of the formula, the main ones being:

— the RPI-X caps "have not been tough enough";[72] that the high levels of profits and returns achieved by the companies have not been consistent with a fair distribution of benefits between the shareholders and customers;[73]

— the disadvantage that the regulator faces in obtaining accurate information about the company's efficient level of forward-looking costs gives the company scope to obscure the picture leading to a built-in tendency to set price caps which are too lax;[74]

— any mistakes made in the setting of prices carry a risk of being magnified by the length of time for which the price control is set. [75]

43. Both the energy regulators argue that the high levels of profits were confined to the initial controls set by the Government on privatisation.[76] The Eastern Group claimed that the Government set the price caps at a level which would make the flotations attractive to investors, that the price caps tended to understate the possible efficiency gains and that the caps were not set on the basis of detailed comparative and evaluative exercises fundamental to subsequent periodic reviews.[77] Both energy regulators believe the net result was that the initial price controls unduly favoured shareholders over customers.[78] We agree, though we find it hard to see how it would have been possible prior to flotation to have accurately estimated likely efficiency gains.

44. In subsequent price reviews the energy regulators have set progressively more stringent price controls, partly because they have become more experienced at operating RPI-X controls, and partly because they have accumulated historic data to help them. [79] At the same time it is becoming increasingly challenging for companies to make continuing efficiency savings and, according to National Power, it will become increasingly difficult for companies to beat X.[80] The evidence suggests that the second and subsequent reviews appear to have passed on a proportion of the out-performance of the first period thus redressing to some extent the balance between shareholders and consumers.[81]

45. However, the GCC is "convinced that the consumer still pays too much for gas" partly because the Council believes that TransCo's costs are inflated.[82] United Gas suggested that some 50% of TransCo's costs are charged in from other parts of the organisation.[83] OFGAS admitted that it was "very suspicious that those [TransCo's] figures are inflated".[84] We received no evidence of equivalent concern about NGC. However, the issue here is not the use of the RPI-X formula in principle, but of the valuation of assets and getting the X factor right. The DGES is of the view, that "to the extent that there has been public concern, it

[72]Mem. p.68.

[73]Ev. p.209.

[74]Ev. p.210, 247.

[75]Ev. p.247.

[76]Ev. p.247; *"Utilities Regulation Consultation for Change"*, Professor Littlechild, Industry Forum Conference, 1995, p.7.

[77]Ev. p.210.

[78]Ev. p.247; *"Utilities Regulation Consultation for Change"*, Professor Littlechild, Industry Forum Conference, 1995, p.7.

[79]Mem. p.34.

[80]Mem. p.34.

[81]Ev. p.210; *"Utilities Regulation Consultation for Change"*, Professor Littlechild, Industry Forum Conference 1995 pp.6-8.

[82]Q.428.

[83]Q.103.

[84]Q.901.

seems to have focused on a sub-set of controls of a sub-set of companies in one particular industry, namely the initial and subsequent distribution price controls of the regional electricity companies in England and Wales". This suggests that any problems with price controls are likely to be "associated with the specific circumstances and treatment of those particular businesses, both at flotation and subsequently, rather than being a generic problem associated with RPI-X price controls for regulated monopolies".[85]

46. With regard to claims that TransCo's cost are inflated, the DGGS told us that "we have never got to the bottom of the charges that British Gas Corporate Centre charges to TransCo or to the public gas supply business".[86] This matter has now been referred to the MMC. This raises a fundamental issue about the amount of information on the regulated business to which the regulator should have access. If the regulator had access to all information available to a regulated company when setting the X factor, the likelihood of forecast performance being exceeded by dint of lower-than-agreed capital and/or operating expenditure could be avoided. While performance better than foreseen by the regulator may be redressed in the following price control round, we do not find it satisfactory that calculating the value of X is, in part, a function of incomplete information. Short-term gain for shareholders through obfuscation is not acceptable and regulators should consider what additional powers are necessary to obtain complete and timely information from regulated companies.

Profit-sharing

47. A common suggestion for regulatory improvement is that RPI-X should be replaced by some form of profit-sharing formula. The DGES states that "RPI-X already does share the benefits of cost reductions": this is done "by setting price limits based on *projected* cost reductions, and by setting subsequent limits reflecting experience of *actual* cost reductions".[87] The prospective benefits of this will therefore be built in to the prices charged under the control.[88] However, shareholders get the rewards first, and customers in the subsequent price review period through lower prices for the future. Research undertaken by National Economic Research Associates has shown that "over time, customers get over 70% of any efficiency improvement, and shareholders under 30%".[89] Whilst efficiency is an important aspect of the price control formula, the economic profits that the monopolies make, even though they derive from out-performance of the regulators' surrogate competition through price controls, may be perceived as "excess" profit gained by the abuse of monopoly power. Whatever the reasons, there have been dramatic profit increases, and it is understandable that consumers are concerned that they might not be receiving their fair share of the benefits of efficiency savings; and it is widely believed that shareholders have benefited far more than consumers (see paras 182-188).[90] Such concerns have led to proposals for reforming the RPI-X regulation formula.

48. Several variants of profit-sharing, such as "annual formula" profit-sharing and "sliding scale" schemes, have been referred to by witnesses. Such schemes would give customers a greater or earlier share of any unanticipated efficiency gains than the RPI-X formula does. Annual formula profit-sharing requires fixed rebates based on the actual profit earned in the year. A profit threshold is determined for the company and, if actual profit is greater than the threshold, then a proportion of the excess profit is returned to customers, usually by way of price reductions or a rebate in the following year. With sliding scale regulation the company can choose to set lower prices in return for a lower rate of profit-sharing. If the profit-sharing scheme is symmetrical as regards risk, then the company might also be allowed to raise prices if profits fell below the given threshold level of profit.

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[85] "*Utilities Regulation Consultation Change*", Professor Littlechild, Industry Forum Conference, 1995, p.7.
[86] Q.901.
[87] "*Utilities Regulation Consultation for Change*", Professor Littlechild, Industry Forum Conference, 1995, p.8.
[88] Ev. p.276.
[89] "*Utilities Regulation Consultation for Change*", Professor Littlechild, Industry Forum Conference, 1995, p.8.
[90] eg. Q.428; Mem. p.93.

49. The main advantages of a profit-sharing mechanism are that it ensures that prices do not get significantly out of line with costs, it creates an automatic correction over any lax price formula and, most importantly, it results in an earlier, more equitable distribution of efficiency benefits between shareholders and consumers.[91] Several disadvantages were also put forward:

— any sanctions on profits would have detrimental effects on incentives to reduce costs compared with the existing RPI-X control;[92]

— although customers might receive a larger share of the profits in the short term, this is likely to be more than offset by the higher cost base which they would ultimately have to bear;[93]

— there is a risk that it would give companies incentives to manipulate profit levels so as to minimise or eliminate any requirement to reduce prices to customers;

— above all, profit-sharing would make regulation more detailed, complex and uncertain as it would involve defining 'normal' and 'excess' profits, and annual discussions between the regulator and the company.[94]

50. After consulting on the issue of profit-sharing, the regulators have, on the whole, rejected the idea in favour of the existing system chiefly on the grounds that extensive annual profit-sharing arrangements are likely to reduce incentives to increase efficiency. For example, the rail regulator opted to start with the RPI-X form of control.[95] According to OFGAS, "evidence from the US, where such a [profit-sharing] form of control has been implemented, does not indicate compensating advantages".[96] The DGES's response has been not to reject it completely. He believes that there is a case for considering alternatives akin to sliding scale regulation in certain circumstances, and has proposed a form of a sliding scale control on NGC's revenue from transmission services.[97]

51. The GCC argues that sliding scale regulation "should not be lightly discarded by regulators".[98] However, the weight of the evidence suggested that profit-sharing has not yet been sufficiently developed. The MEB believes "that such an approach requires further careful consideration and investigation, with possibly a limited trial to assist wider debate, prior to any serious consideration being given to its introduction in the future".[99]

52. None of the witnesses put forward definitions of 'normal' or 'excess' profits, thus reinforcing the view that such terms would be difficult to define. The MEB believes that the regulators "have tended not to commit themselves other than in broad terms" to addressing these issues.[100] With regard to the determination of the proportion of the profits to be returned to customers, a 50:50 split was suggested, but reasons to support this ratio, as opposed to any other, were not given; nor was there any discussion of the implication this would have for the incentive regulatory framework.

53. The MEB argued that the nature of profit-sharing within the current RPI-X regulation is not explicit and is, therefore, not well understood.[101] The extent to which this contributes

[91] eg. Ev. p.176; Ev. p.96.
[92] Mem. p.31.
[93] Mem. p.34.
[94] eg. Mem. p.85; Ev. p.191.
[95] Mem. p.18.
[96] Ev. p.248.
[97] Ev. p.276.
[98] Ev. p.96.
[99] Mem. p.31.
[100] *Ibid.*
[101] *Ibid.*

to the dissatisfaction with the current regime, rather than a belief that there are fundamental flaws with the RPI-X formula, is unclear. A more explicit form of profit-sharing might be more acceptable politically, but whether profit-sharing is on balance a desirable alternative to RPI-X regulation depends on judgements of the extent of the disincentive to efficiency, the increased regulatory burden and the relative weights placed on efficiency and equity objectives. We were interested by the Director General of Water Supply's recent proposals for a voluntary acceleration scheme for the earlier sharing of profits with consumers: because it is a voluntary scheme it should not destroy incentives to efficiency.[102] By its very nature, such a scheme cannot be imposed by Government or the regulators; nevertheless, we urge companies to consider voluntary acceleration.

54. British Gas argued strongly for a profit-sharing mechanism to be introduced alongside the current RPI-X control for a different reason. It pointed out that RPI-X regulation provides strong incentives to achieve efficiency gains at the beginning of the price control period compared to the end of the period. British Gas told us that "savings made earlier in the formula period were worth far more than savings made toward the end because lower costs, under gas regulation thus far, are incorporated in the revised and lower cost base for the next period".[103] It believes that the formula encourages a short-term focus on efficiency gains and that a better balance needs to be achieved between the short-term interests of gas consumers and the need to finance the business. Essentially British Gas's concern is that the company's shareholders will not benefit from the lower cost level created as a result of its restructuring programme; instead the benefits will be passed to consumers through lower prices. British Gas considers that a profit-sharing system would allow the efficiency incentives to be the same throughout the period, and it would prefer a profit-sharing system which would allow some element of 'roll-over' of cost-savings whereby benefits accrued to shareholders as well as customers. OFGAS rejected British Gas's proposal on the basis that it was potentially subjective, interventionist, and the calculations involved would be complex. Instead, OFGAS proposed a risk sharing mechanism relating to the costs associated with the introduction of competition in domestic gas supply.[104] We think that British Gas's point about RPI-X regulation providing stronger incentives to efficiency in the earlier years is an important one. However, it appears to us that the proposal which British Gas have put forward would benefit shareholders the most. We support the DGGS's decision not to introduce British Gas's proposals.

55. None of the options we have examined is perfect. Although many witnesses criticised the RPI-X form of incentive regulation by periodic review, the weight of our evidence did not support a move towards a rate of return approach.[105] In fact, witnesses regarded the rate of return method as having significant and numerous deficiencies compared with the RPI-X formula.[106] The arguments for incentive regulation are powerful and the advantages of the RPI-X incentive regulation outweigh those of rate of return, and other forms of profit-sharing, such as annual formula profit-sharing and sliding scale regulation, because they are likely to erode incentives. Therefore, the RPI-X form of incentive regulation has much to commend it over other methods, above all, because it provides powerful incentives to companies to reduce costs through efficiency improvements, a feature we regard as central in any formula chosen. The weight of our evidence suggests that there are strong arguments in favour of the continuity and fine-tuning of the current formula. Given the complexity of price control regulation and the clear advances being made by regulators, we would regard the abandonment of RPI-X as being a reaction to past deficiencies. We therefore support the continuation of RPI-X incentive regulation in its broadest sense on the grounds that it is essential for the maintenance of effective incentives to efficiency but believe that further work needs to be done to improve the estimation of X. We recognise that profit-sharing has not been sufficiently developed or tested and we do not rule it out as an option for the future. **We recommend that the use of RPI-X incentive regulation be continued.**

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[102] Ev. p.237.
[103] Ev. p.313.
[104] Ev. p.248.
[105] eg. Mem. p.31; Ev. p.114.
[106] eg. Ev. p.324.

The review period

56. The DGGS has set a 5 year price control for British Gas TransCo,[107] while the DGES has opted for a 4 year duration for transmission and 5 years for the distribution price controls of electricity. The DGES believes that a price control period has to be sufficiently long to give the company a period of relative certainty within which it can work to reduce costs, and undertake investment, with the knowledge that the cost savings are not going to be taken away from it, but not "so long that conditions can change, so the control can turn out to be far too lax or far too tight".[108] In his opinion "a period of 4 to 5 years is about the sort of time".[109]

57. Companies generally disagreed with this, claiming that they need a longer period to improve efficiency and undertake investments. The only persuasive argument for a longer price review period was that put forward by the NGC. NGC claimed that the "periodic reviews of prices which the company is allowed to charge for use of its system are on a far shorter time-scale than the asset lives".[110] "Accordingly, significant change by the regulator from one review period to the next of one or more key financial variables which determine the final RPI-X price control can considerably undermine the capacity to ensure a stable background for continuing investment".[111] We are not convinced. NGC's argument appears to be based essentially on the lack of consistency in the regulatory framework, particularly with regard to the calculation of the asset base and the cost of capital which determines allowed revenue. If the regulator were to adopt a more consistent approach to calculating NGC's valuation of assets and allowable revenues (see paras 67 onwards), then there would be no reason for extending the price control period beyond 4 or 5 years. In any case there is a risk that, if the review period were to be extended, there would be greater temptation to revisit it in between the reviews if any of the variables or assumptions were to change significantly.

58. NGC argued very strongly for a 5 rather than a 4 year price review period, during the recent transmission price control review. After consideration and consultation, the DGES rejected their proposal and concluded that a 4 year price review period should remain. His arguments were based on the fact that there was scope for considerable change in the transmission business, and there was uncertainty about the level of new competition entering the market and the level of NGC's non-controllable operating costs and that he took developments further ahead than 4 years into account in his price control review.[112]

59. The length of the review period chosen depends very much on the circumstances within the industry. For example, with further liberalisation of the gas and electricity markets, the regulators may think it appropriate to review some sectors more frequently until the markets settle. There are nonetheless strong arguments for 5 years in transmission, particularly as experience is gained with the passage of time and forecasts improve and the amount of inefficiency remaining is reduced.

60. There has only been one occasion when an energy regulator has reconsidered a price review. The DGES, in March 1995, decided to reconsider distribution prices less than 12 months after completing the first review but before the new regime was formally in place. This occurred because the DGES came to the view that the price control he had proposed in August 1994 was no longer appropriate, as circumstances had changed sufficiently since setting the original controls. He argued that essential new information had come to light concerning share price movements and the terms of the Trafalgar House bid for Northern Electric.[113] The DGES believed that "although re-examining the proposed controls might

[107] OFGAS press notice, 21.7.96.
[108] Q.1013.
[109] Q.1013.
[110] Ev. p.44.
[111] Ev. p.41.
[112] OFFER, *The Transmission Price Control Review of the National Grid Company: Proposals*, 1996, pp.6-7.
[113] OFFER, Annual Report 1995 pp.28-29.

increase uncertainty in the short term, I considered that this was preferable to the risk that, if I did nothing, the implemented controls might need to be re-opened before the end of their five year term."[114] We examined the DGES's decision to re-open the price control review at length in our report *Aspects of the Electricity Supply Industry*, July 1995 (HC 481-I) in which we were critical about the rigour with which the DGES had scrutinised distribution and transmission revenue and costs. We concluded that, on balance, the DGES was right to re-open the review, mainly because "the review was reopened before the revised price control had come into effect and during the period allowed for representations or objections, and the very idea of inviting representations or objections must indicate that a reconsideration is possible".[115] We then recommended that "such a procedure be avoided in the future", so as not to create regulatory uncertainty and undermine the credibility of the regulatory system.[116]

61. Several witnesses argued that, if the regulators were to re-open a review as a matter of course, price regulation would deteriorate into a complicated form of rate of return regulation,[117] it would undermine the regulatory contract, affect investors' legitimate expectations and "will tend to increase the cost of capital, to the ultimate detriment of customers".[118] The DGES told us that the circumstances have to be "pretty exceptional" before a price review can be re-opened and he does not see "major events occurring over the next few years that would necessitate re-opening a price control".[119] We recognise that revisiting a price review can cause instability, which could be detrimental to the industry given the need for long-term investments; however, no one reported to us any significant adverse affects resulting from the re-opening of the electricity distribution review. Our conclusion remains the same as before. We believe that regulators should not in general re-open price reviews, for reasons of consistency, equity and the maintenance of incentives, although we cannot rule it out completely where there have been significant and exceptional changes in circumstances.

The Retail Price Index

62. The RPI has been used in the price control formulae in order to link the annual price changes to the level of inflation. The Public Utility Reform Group (PURGe) argued very strongly that the use of RPI, which they called a crude proxy for the rate of inflation, resulted in higher prices to consumers than if a more suitable index, such as the RPIY, was used. The RPIY index excludes indirect taxes and mortgage interest payments and it is for this reason that PURGe regard it to be more suitable. PURGe argued that, during the period August 1989 to August 1991, the RPI rose by 18.9%, whilst the RPIY rose by only 13.7%, resulting in regulated companies being allowed to raise prices by 4.5% more than they could have if the RPIY had been used.[120] The Bank of England were more cautious about RPIY and pointed out that "while RPIY was below RPI ...for all of 1994 and 1995, this relationship has not held at all times in the past and, for substantial periods the relationship was reversed."[121] We believe that the real issue here is not whether a lower price index should be used but which index is the most appropriate.

63. There are good arguments for keeping the RPI element. It has the advantage of being simple and generally understood by the public. OFTEL rejected RPIY, after considering it, specifically on the grounds that it is less well known.[122] Also, as OFGAS pointed out, other

[114] OFFER, Annual Report 1995 p.7.

[115] Eleventh Report from the Trade and Industry Committee, Session 1994-95, on *Aspects of the Electricity Supply Industry*, HC 481-I, para 94.

[116] *Ibid.*

[117] eg. Mem. p.96.

[118] Ev. p.209.

[119] Q.1014.

[120] Ev. p.144.

[121] Mem. p.1.

[122] Ev. p.144.

considerations are taken into account in setting X and, as RPI-X is relatively crude anyway, using another index such as RPIY would make very little difference to the price control.[123]

64. Both the energy regulators rejected using industry specific indices, which would more closely reflect the costs of the particular industry. The DGES believes that the use of any other index would cause confusion and suspicion among consumers. He told us "they will not know what that is and ... they will begin to get suspicious: how is this index constructed and who is to say that the companies are not influencing that in some way. What we would end up with if you went down that route is a series of different indexes" both between industries and within them for different sectors.[124]

65. We believe that the arguments for keeping RPI are much stronger than those for moving to RPIY or any other index at present. If prices are higher than they should be it is not because of the use of RPI rather than RPIY in the formula, but because X has not been set as accurately as it could have been. Confidence in the formula can only be sustained if improvements are made to the methodology for calculating X. **We therefore recommend that regulators continue to use RPI as a measure of inflation in the price control formula while continuing to seek improvements in the methodology for estimating X.**

Determination of price levels

66. The price cap the regulators set must allow the regulated company to cover its forecast costs from sales revenue. The calculation of price caps is based on assessments of the company's operating costs, capital expenditure, the annual depreciation charge and the cost of capital (new and existing). This information is also used to arrive at X, the appropriate factor for productivity improvements through the review period. Several witnesses considered this to be an enormously difficult task as companies have the incentive to overstate their costs and investment requirements.[125] For example, Enron pointed out that British Gas's capital investments were substantially over-estimated from the beginning, and that "they [British Gas] were underspending their estimated capital for the purpose by an average of 30% a year".[126]

67. With regard to operating costs and capital expenditure, regulators use a variety of methods to examine the companies' projected expenditure requirements and the scope for companies to improve their efficiency. Such methods include comparisons between companies affected by the review, comparisons with other companies at home or abroad, comparisons with past expenditure and performance, advice from consultants, discussions with other companies in the industry and cross-checking of information provided with independent sources.[127]

68. The evidence from the National Grid Company and British Gas indicates that there is a great deal of contention between the industries and the regulators about the principles of calculation of the annual depreciation allowance, the asset base, and of the cost of capital. These elements are vitally important because they affect the total allowable revenue on which X is based.

69. The main criticisms centred around inconsistency from one review to another in the regulators' approach to the basis on which assets were depreciated and the cost of capital.[128] Both OFGAS and OFFER have decided during the most recent price reviews to change the basis of calculating regulated revenues. OFGAS has proposed basing depreciation and the rate of return on acquisition costs, whereas in the past the current cost accounting basis has been

[123] QQ.883-885.

[124] Q.1016.

[125] eg. Ev. p.84.

[126] Q.346. Enron are apparently referring to OFGAS's proposal for the British Gas TransCo Price Review, which stated "W S Atkins recommended that TransCo's forecasts of new capital expenditure over the period 1997-2002 should be reduced by 30% in line with previous over-estimates".

[127] *"The Work of the Directors General"*, 1996, p.25.

[128] Ev. pp.44-47.

used; and OFFER has moved to a market-based asset valuation more closely related to acquisition cost. Both British Gas and the NGC have strongly opposed these moves because they claim that they have created an uncertain environment for future investments and increased regulatory risk which "pushes up the cost of capital, making the business higher-risk from the investor viewpoint".[129] One example of this is the TransCo formula which was announced in May 1996 and resulted in British Gas's share price falling by 30% and settling around 25% lower.[130] The NGC summarised the outcome of these changes as "the regulated transmission businesses ... face the continuing risk of seeing large parts of their asset bases written off for regulatory purposes, while being allowed to earn rates of return (on the remaining assets) which are premised on them being low risk businesses. This is not a reasonable basis for investing in vital infrastructures. In particular, it does not have the internal consistency which characterises US regulation, where relatively low rates of return co-exist with the understanding that, once assets are in a company's regulatory base ... they are in the rate base for the agreed life of the assets".[131]

70. The NGC, among other companies, called for clear and consistent rules on key factors such as the cost of capital, the regulatory asset base and treatment into future of efficiency gains above 'target' from past review periods" as being essential for a more stable process and for encouraging long-term investment in national infrastructures.[132] Consistency on the cost of capital was seen as the key area, so "that in each period we do not keep on re-visiting this figure".[133]

71. We believe that there is a strong case for having clear and consistent guidelines, especially on how the regulatory asset base should be calculated and whether the principle will carry through to the next review period. We note that, partly as a result of recent MMC inquiries, greater consistency is being shown. **We, therefore, recommend that the regulators develop such clear rules and communicate them, and any subsequent changes, to the regulated companies.**

72. The rate of return on capital employed (i.e. profits and loan interest) should be set as low as possible to minimise the cost to customers, but high enough to allow an efficient business to attract capital necessary for investment. The regulators have recently set the real rate of return on capital at 6% to 7%.[134] The rate of return was generally arrived at after consultation, analysis of rates of returns obtained in the securities markets and assessment of the effect of taxation or, as in the case of OFGAS, the work done by the MMC in 1993.

73. Several witnesses argued that there was a lack of common methodologies for price setting among the regulators. Dr Dieter Helm believed that one result of this was a "higher cost of capital which raises the long run prices to consumers".[135] South Western Electricity plc (SWEB) suggested that "a new panel should be created to consider and establish a common methodology for sectoral regulators on the main regulatory issues such as asset valuation, depreciation and cost of capital" which should be published.[136] The Director General of OFWAT told us that "we [regulators] are also learning a lot from each other in terms of process".[137] The balance of evidence suggests that "over the years ... [the regulators] have actually arrived at very common methodologies across the price controls", particularly in terms of the asset base and the rate of return, and particularly in gas and electricity, very similar approaches are emerging.[138] The DGGS told us that the approach to the rate of return "varies slightly according to the level of risk in the particular business

[129] Ev. p.41. *See also* Q.34.
[130] Q.34.
[131] Ev. p.46.
[132] Ev. p.42. *See also* Q.235.
[133] Q.182.
[134] eg. Q.483.
[135] Ev. p.121.
[136] Ev. p.59.
[137] Q.857.
[138] Q.898. *See also* Q.857.

concerned".[139] The regulators have made good progress in this area and, providing this continues, we do not think there is a need for special panels for this specific purpose. While we accept that industries have different characteristics, and inconsistencies between industries may arise, **we recommend that individual regulators should seek to improve their calculations by taking account of regulatory practices in other industries with the aim of achieving greater consistency. This is especially important for energy regulators whose different methodologies could distort the choice of energy source.**

Developing Competition

To promote or to secure?

74. Both energy regulators now have a statutory duty to develop competition.[140] Under the Gas Act 1995, the DGGS has a duty to "secure effective competition in the carrying on of the supply and shipping of gas".[141] Under the Electricity Act 1989, the DGES has a duty to "promote competition in the generation and supply of electricity."[142] During the course of our inquiry, considerable debate has turned on differences between these duties and, more precisely, on whether there is a practical difference between securing effective competition and promoting competition.

75. Mr Eggar told us that "it is a feature of the art of the parliamentary draughtsman ... that differences [in wording] do emerge from time to time and it is sometimes not very easy to explain them".[143] He believed that in, practical terms, there was little difference between the duties of the two regulators in regard to competition.[144] Professor Littlechild also told us that he was not aware of any practical difference between his duties and that of the DGGS in relation to competition.[145] Lord Fraser told us that the difference seemed "in principle to be essentially a stylistic matter rather than any attempt to confer upon the different regulators different powers".[146] It is clear, however, that this is not a universal opinion. Ms Spottiswoode told us "there is a very big difference ... promoting is less active than securing".[147] Indeed, OFGAS fought hard to have 'secure' in the 1995 Gas Act, which indicates the importance it, at least, attached to having such terminology in the legislation.[148] The EIUG told us that the different terminology in the two Acts was "of great concern to energy intensive companies" and that "these phrases are vital to development of the markets to the benefit of customers".[149] Ms Waters, policy adviser to the EIUG, argued that the use of the word 'secure' in the Gas Act offered "industrial customers the ability to turn round and say to the regulator 'this is not effective competition'"[150] but that, in contrast, if that was said to the electricity regulator, "he has every right to say 'but I am doing my best, I am promoting it'".[151]

76. While we have some sympathy with the argument put forward by the EIUG, we conclude that the argument is in reality over nothing more than semantics. Certainly, we have detected no sign that the Government, in passing the legislation, intended there to be any

[139] Q.898.
[140] Before the passage of the Gas Act 1995, the DGGS had a duty only to assist competition.
[141] Gas Act 1996, (Section 4(1)).
[142] Electricity Act 1989, Section 3(1).
[143] Q.288.
[144] *Ibid.*
[145] Q.1011.
[146] Q.1101.
[147] Q.866.
[148] QQ.448, 866.
[149] Ev. p.110.
[150] Q.448
[151] Q.448