

**REPORT  
TO  
THE BOARD OF GOVERNORS OF THE UNITED STATES POSTAL SERVICE**

**THE RATEMAKING PROCESS  
FOR  
THE UNITED STATES POSTAL SERVICE**

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OF THE UNITED STATES POSTAL SERVICE  
BY THE INSTITUTE OF PUBLIC ADMINISTRATION**

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**EXECUTIVE SUMMARY**

At the request of the Board of Governors of the United States Postal Service (the Postal Service), the Institute of Public Administration (IPA) undertook a study of the ratemaking process under a contract executed May 21, 1991. The focus of the report is the process by which prices are set for the variety of mail services, and the impacts of that process on the ability of the Postal Service to perform its mission effectively and efficiently, particularly with respect to criteria of fairness, flexibility, timeliness and simplicity.

The ratemaking process has had negative impacts on the Postal Service's ability to serve the public, on its financial condition, and on its competitive services. Major revisions are required. If the PRC and the Postal Service can collaborate to devise comprehensive rule and classification changes, a good deal of the revision can be achieved without legislative action. If not, comprehensive amendment of the Postal Reorganization Act is required.

**I. FINDINGS: FLEXIBILITY PROVIDED FOR IN THE LAW HAS BEEN LOST.**

The Postal Reorganization Act of 1970 provides for a great deal of flexibility for selection of pricing methods, for rules of procedure, and for classification of mail services, but that flexibility has been restricted by cumbersome rules and practice to the point where the existing process inhibits innovation and service improvement,

impedes competitive performance, and is leading the Postal Service into declining financial condition. Over the twenty-year period since reorganization, the ratemaking process has become increasingly rigid despite changes in the environment in which the Postal Service operates that require more flexibility if it is to provide the "efficient and economical" operation called for in the law.

A look at regulatory processes in other systems, including state public utility commissions, federal agencies such as the Interstate Commerce Commission, Federal Communications Commission, and Federal Energy Regulatory Commission, and postal services in other industrialized nations, all show a contrast with the rigid, lengthy, and complex procedures of U.S. postal ratemaking. Postal ratemaking has thus far been left out of a decade of regulatory and public enterprise reform.

The process of ratemaking for the Postal Service is continuous. Preparation for an omnibus rate case, which occurs at least every three years, begins when implementation of the previous rate case is getting underway. This is a disproportionate drain on resources and leadership attention of the Governors, of the Postal Service, of the Postal Rate Commission members, and of the mailers who feel it is necessary to be active intervenors either directly or through associations. Throughout, the public is not well served.

**RECOMMENDATIONS:** A joint task force of the Board of Governors and the Postal Rate Commission should be established to develop priorities for a comprehensive revision of the rules governing ratemaking and classification and to map out a strategy for reform of the process.

- **Ex parte** rules should be modified to provide exemptions for policy communications between the Board and Commission that are not related to a single case.
- Special staffing for the task force should be designed to assure a fresh approach and objectivity.
- Changes in other organizations should be looked at to provide benchmarks from which to work (e.g., see California, United Kingdom, and federal regulatory agencies.)

If necessary Congress should mandate that the Postal Service and the PRC



cooperate to revise rules and practice in order to return to the spirit and intentions of the Postal Reorganization Act.

If the collaborative approach does not prove feasible, the Postal Service should prepare a comprehensive revision of the rules and request a formal rulemaking case from the PRC.

## II. FINDINGS: CONTROL OF SERVICE CHANGES IS TOO TIGHT.

The ratemaking process, or the process by which Postal Service decisions are subject to prior review by the Postal Rate Commission, involves much more than the tariff or price schedules of public utilities that are subject to regulation. Every change in service by the Postal Service--large or small--is subject to prior review. This is because of an exaggerated interpretation in PRC rules and practice of the clause in the Act that requires, "each class of mail or type of mail service [to] bear the direct and indirect postal costs attributable to that type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type." This provision has been applied by the PRC not only to major classes and types of mail but to 34 subclasses and hundreds of rate categories--in fact to any small change in service that has any impact on rates to any group, large or small.

Every action by the Postal Service can be examined to see to what extent it may change the price/cost relationships among customers. For shorthand, this interpreted requirement is called the "no-cross subsidy" requirement. (The phrase "cross subsidy" is not used in the Postal Reorganization Act).

The problems with this approach are exacerbated by the fact that the definition of subclasses is increasingly obsolete as automation progresses; the defined subclasses and rate categories are not well related to the actual costs of handling the mail or providing the service. Despite the data demanded by the PRC, the subjective elements in the classification and cost attribution processes are necessarily high.

Experiments, market tests, local post office improvements in service, all have been subjected to this restriction since a federal court, in a case brought by United Parcel Service (UPS), ruled in 1979 that experimental efforts are not exempt from

prior review. (604 F.2d 1370). Every change proposal is examined in advance by the PRC, which imposes hard data requirements that go well beyond what is reasonable for business or service estimates for the future. Competitive firms--e.g., Federal Express and United Parcel Service--aggressively pursue roles as intervenors in PRC rate, classification, rulemaking, and complaint cases, arguing issues of cost allocation among mailers that have no direct relevance to them, but very great indirect relevance, in so far as the PRC recommendations may add to the cost allocations (and therefore prices) of Postal Service competitive services and constrain Postal Service innovation and service enhancement.

Classification and rule-making cases have taken more than 15 months for PRC decision (they are not subject to the statutory 10-month limit of the omnibus rate cases). For example, the 1988 Postal Service request for a rules change in order to allow expedited decision on Express Mail rates, took an unexpedited 15 months just to reach the point of publication of proposed rules, and then provided rules with such complex data requirements that the Postal Service finds them unhelpful. The PRC rules reflected a counter proposal by the PRC Office of Consumer Advocate that in turn reflected many of the arguments of Federal Express, UPS, and other competitive interests.

#### **RECOMMENDATIONS:**

- Classes of mail and types of service should be redefined to get back to basic, simple, important categories, to eliminate prior review of detailed components of service and to better reflect actual costs of handling.
- Experimental authority should be restored to the Postal Service by legislative amendment.
- Time limit of 4 months should be set for PRC hearings on matters exclusive of omnibus rate cases; notice and comment proceedings, legislative-type hearings, and settlement proceedings should be authorized for such cases.

### **III. FINDINGS: THE RATEMAKING SYSTEM IS NOT PROTECTING THE SYSTEM FROM FINANCIAL LOSS.**

The Postal Service is steadily losing money and building debt. The ratemaking process is not providing for the financial health of the organization. These trends, together with large retirement benefit costs that are not being included in current expenses and rates, mean that there is a massive subsidy of current mailers by future mailers or future taxpayers or employees.

The Postal Service has reported net operating losses in four out of six years (1985-1990), and 1991 will make it five losing years out of seven. Moreover, the losses are greater than the gains in net income years; net reported cumulative loss in 1985-1990 was \$1.6 billion, and net loss at current rates for fiscal years 1991 and 1992 will total over \$1 billion according to Postal Service estimates in September 1991. Since reorganization, cumulative net operating losses have reduced Postal Service equity from +\$3 billion to -\$1.3 billion, an equity decline of \$4.3 billion. The amount allowed in the ratemaking process for recovery of prior year losses--one-ninth of the cumulative loss--is insufficient to offset the current rate of loss, but in any case it is not being earmarked for equity or debt reduction; all revenues are used for operating expenses and to some extent to delay the filing of the next rate case.

Total liabilities are higher than a full year's budget. They include \$7 billion in long term debt (expected to double in the next several years), \$28 billion in other reported indebtedness, and unaccrued liabilities ranging from \$6 billion to more than \$ 51 billion, depending on whether one includes health care benefit liabilities. Whether or not one includes the present value of health care costs in the liability equation, they are going to rise very rapidly. If the liability were amortized over a twenty-year period, these expenses alone could trigger a 5¢ to 7¢ increase in first class letter rates, in effect overwhelming productivity savings. These factors have not been included in the revenue requirement on which rates are based.

Moreover, the Postal Service is undercapitalized relative to comparable business



and government enterprises. It depends almost entirely on borrowing for capital investment, and it uses a depreciation rate that does not provide for replacement. The lack of any capital reserve fund inhibits improvement of services.

The way in which "breakeven" is defined in the ratemaking process, the use of a single prospective "test year", and the three-year cycle of omnibus rate cases virtually assure that financial performance in the long run will fall short of the financially healthy, self-sustaining entity called for in the Postal Reorganization Act. None of these basic characteristics of the rate-making process -- "breakeven", test year, or three-year cycle of rate cases -- is required by the Act. The design of the process and decisions on how to "provide sufficient revenues so that the total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs..." were left to the Postal Service and the PRC to work out.

Because of the length of the omnibus rate case (30 months from beginning of case preparation in the Postal Service to final PRC opinion after two reconsiderations in the 1990 rate case), the information on the record bears little realistic relationship to actual costs and revenues at the end of 1991. The environment of rapid change in technological, economic and financial factors renders obsolete the ratemaking process that depends on the PRC making judgments in late 1991 based upon projections from the 1989 base year and expected to produce breakeven financial performance in 1992.

The narrow definitions of the test year and performance of breakeven, without provision for balancing gains and losses overtime or for reserves, are not found in other postal services we reviewed or in regulated enterprises in the United States. Private companies, including those which compete with the Postal Service, plan for revenues over-time to cover costs plus some reasonable return or profit. Factoring out any profit that may be distributed to stockholders or managers, a portion of return to provide for downturn years and for capital reserves is generally considered essential for doing business in a dynamic enterprise, public or private.

**RECOMMENDATIONS:** Either by rules or by congressional action (preferably the former, in order to retain flexibility for change over time), the definition of "breakeven" should be changed to bring the process into line with the legislative intent to balance income and estimated costs over time. Provision for a modest return for capital reserves should be included (replacing the contingency factor).

- The timing, data requirements, and procedures of the process must be changed to allow decisions to be based on both forecasts submitted for the record and up-to-date economic and financial information.
- The breakeven test year should be replaced by use of a test period (e.g., a four-year rate plan period) over which true financial self sufficiency can be developed.
- The Postal Service should plan for managing increasing retirement benefit costs and their impacts on rates.

**IV. FINDINGS: THE RATEMAKING PROCESS IS NOT LINKED EFFECTIVELY TO PLANNING, BUDGETING OR LEADERSHIP OBJECTIVES IN THE POSTAL SERVICE.**

The ratemaking process exerts pressures on the Postal Service that require:

- 1) Focus on short-term costs rather than long-term objectives;
- 2) Present action to be shaped by past data rather than by strategic objectives for innovation and service enhancements;
- 3) Finite calculations concerning potential cross subsidy among narrowly defined subclasses and rate categories for mail. These calculations crowd out considerations of how to develop broad revenue patterns to support the basic public services at reasonable rates and to maintain diversified services.

The substance of hearings and discovery proceedings before the PRC is full of statistical minutiae and repeated debates over economic theories, having relatively little to do with the mission, financial performance, and public service objectives of the Postal Service. This also limits public accountability. Few people understand the proceedings except the usual intervenors--attorneys for competing firms and large



mailers, association representatives, and economic consultants--a number of whom previously worked for the Postal Service, and the involved Postal Service and PRC staffs. Certainly others are not likely to read the 25,000 pages of record from the 1990 rate case! Chapters II and III of this report try to describe the process in comprehensible terms, but even this level of description requires considerable effort to follow.

At the top levels in the Postal Service, strategic planning, marketing and financial planning capabilities are in place, but the lack of linkage to pricing policy inhibits application of these capabilities. The revenue requirement and proposed rate schedules used in the ratemaking process are overly dependent upon volume forecasts, historical data, and econometric models, which the Postal Rate Commission insists on as the basis for proposals. The process limits management judgment. This emphasis is in stark contrast to business pricing methods, and to the trends for both regulatory reform in the United States and foreign postal services.

The Postal Service prepares two budgets (internal and external), which have different fiscal years. The relationship among the numbers from the two budgets and rate case proposals is only understood at the top levels of financial management. Selective rate case numbers are injected into the internal budget at the aggregate level, which is then broken down by operating units, so that field managers are asked to manage to specified totals, but these operating budgets are not effectively related to strategic priorities or to the ratios used in the rate cases. When a new rate case is prepared, the proposal begins with new assumptions; it appears that no systematic assessment of performance related to the assumptions in the previous case is undertaken by either the Postal Service or the Postal Rate Commission.

The Governors are required to make complex decisions in the ratemaking process with limited planning and budgeting backup. The Postal Rate Commission makes its decisions with practically no factors of strategic efficiency, effectiveness and long range health of the enterprise before it. The information it asks for sheds little light on these essential management dynamics.

## **RECOMMENDATIONS:**

A. The basis for the next omnibus rate case should be a four-year rate plan submitted by the Postal Service, instead of a single test-year projection. The PRC review should follow reformed procedures developed by the task force or mandated by legislation described in the first recommendations above.

- The rate plan should be based upon a four-year financial plan and underlying consolidated program budgets prepared by the Postal Service and approved by the Board of Governors.
- The rate plan should provide for a ceiling on aggregate rate increases to meet estimated revenue requirements over the four years, with appropriate rate schedules.
- The plan should provide for financial self-sufficiency over the period, including reasonable provision for recovery of prior net losses either through rates or other means that may be developed.
- The Postal Service and the PRC should agree on categories of information that should back up the submitted plan. These should become regular products of budgeting and information systems, reducing requirements for special statistical studies for ratemaking.

B. Reformed procedures to be combined with the four-year plan should include authorization for annual or biennial rate increases within specific formula parameters. This approach should be designed to: (1) give the mailers better information in advance of likely rate increases; (2) even the increases out over time; (3) provide self-imposed cost reduction incentives for the Postal Service; (4) put a four-year ceiling on rates moveable only in response to defined external events (e.g., congressional action); and (5) lengthen the time between major rate cases. (Examples of similar procedures are described in Chapters V and VI.)

- The formula should be based upon gross national product price index or another index more closely related to Postal Service costs with a subtracted incentive factor for productivity improvement (e.g., GNP-PI minus 2 percent), and added exogenous cost factors (such as congressional budget actions, or retirement benefit expense increases).
- Within the parameters of the plan approved in the rate case, annual increases would be permitted on 90-days notice. The PRC should

or be priced at increasingly higher rates. Two strategies are required:

- 1) Constant improvement and enhancement of existing core services to offer value relative to competing modes. This means that the strategic priority for traditional postal services should be control of costs, increased productivity and efficiency, introduction of new products and, above all investment in improved reliability, speed, and consistency.
- 2) The Postal Service should be permitted to compete on "level playing fields" in services that could in the future contribute growing amounts to institutional costs, including Express Mail and priority mail.

The ratemaking process has worked against both of these strategies. It has contributed to the dramatic decline of Express Mail and Parcel Post shares of growing markets. It has taken the Postal Service out of high technology transmission. It has prohibited the Postal Service from competing for federal government delivery contracts. It has eliminated the normal enterprise opportunities for innovation, experimentation, market tests, and service improvements. The PRC has taken the position that the Postal Service could shrink into its protected service niche, and still provide the basic services at reasonable costs. This is no longer a tenable objective, as the overseas postal services demonstrate. If the Postal Service is not a dynamic enterprise, its core public services will stagnate and prices will escalate.

If the PRC proceedings continue to focus on revenue requirement as if it were a static "pie" to be divided up by competing mailers' groups, with influence of Postal Service competitors on how the pie is cut (aimed at reducing Postal Service competitiveness), it is the loyal but frustrated customer of basic postal services who will suffer. (The Officer of Consumer Advocate of the Postal Rate Commission has much more effectively represented competing businesses than the Postal Service customer.)

#### RECOMMENDATIONS:

- Legislative amendment should provide for the Postal Rate Commission to review Postal Service proposals to classify certain service segments as competitive (segments in a competitive market situation that do not have a dominant market share). Such segments of business would be



conduct annual review based on the written record to assure that rate increases conform to the plan. If the PRC found that they did not, it could issue an opinion to the Governors recommending changes.

C. As reformed procedures are developed and tested, the omnibus rate case may not be necessary at all. Annual updating of the Postal Service rate plan and annual review by the PRC may become the general procedure. Specialized proceedings could be maintained for the many procedural and costing methodology issues that remain to be resolved.

V. FINDINGS: THE CURRENT RATEMAKING PROCESS HAS CONTRIBUTED TO THE DECLINE OF COMPETITIVE SERVICES OFFERED BY THE POSTAL SERVICE, BUT THE SUCCESS OF COMPETITIVE SERVICES ARE ESSENTIAL TO EFFECTIVE PROVISION OF PUBLIC SERVICE AT REASONABLE RATES.

While the legal letter monopoly provided by the Private Express Statutes is partially intact (depending on the future interpretation of the expedited mail exception which is edging into second and third day delivery), the strategic monopoly has deteriorated. Just as other modes of travel challenged the monopoly rail lines, today electronic mail, automatic funds transfer, fax machines, and many other modes are challenging letter mail. These competitive forces cut into Postal Service business in the 1980s more slowly than predicted because the overall volume in the messaging industry was growing rapidly and because consumer behavior change lagged behind technology change. But the Postal Service is extremely vulnerable to volume stagnation or declines in this decade.

As other industrialized nations have recognized (and the plans for the European Community reflect), public policy that basic universal service be provided at uniform and reasonable prices is challenged by technological and market changes that subject every aspect--including protected letter mail--to increasing competition and volume uncertainty. Unless the volume of letter mail increases in pace with fixed costs, including the costs of the massive free delivery system in which addresses grow regardless of letter volume, the basic services will have to be cut back, be subsidized,

subject to a distinct procedure of expedited review dealing only with evidence on the record that they are paying their incremental costs. (Examples are given in Chapters V and VI).

- Changing rules and procedures should develop in stages to recognize two or three segments of Postal Service activities by criteria of competitiveness and apply selective regulation to these segments.
- Postal Rate Commission rules and Postal Service costing methodology should be modified to recognize that total revenues in a competitive environment respond in complex ways to prices, investment in service improvement, timing, and customer relations. (Examples are given in Chapter II). The full range of factors listed in the Postal Reorganization Act should be used in redefining rate criteria.
- The Postal Service should be permitted to enter into contract letter and parcel delivery business on the basis of approved tariff plans and fairness guidelines to protect the interest of small mailers. (Examples are given in Chapters V and VI.)

**VI. FINDINGS: THE CURRENT RATEMAKING SYSTEM IS PROCEDURALLY CUMBERSOME WELL BEYOND PROPORTION NEEDED TO MEET THE LEGISLATIVE MANDATES.**

The ratemaking process has been turned into an elaborate effort to prevent cross subsidies among 34 subclasses of mail and hundreds of rate categories or service changes. The PRC strives for "econometric rigor" and "historical hard data"; the Postal Service tries to accommodate those demands. The result becomes extraordinarily complex, costly, time consuming and nonproductive. For all the efforts to be quantitatively objective, there is necessarily a broad range of subjective judgment involved in cost allocations. Rate cases do not and cannot objectively deal with issues of cross subsidy among finite differences in the handling costs of scores of activities. The process has become an end in itself, losing sight of the purpose of maintaining a fair and efficient Postal Service rate system.

This approach is exacerbated by the PRC reliance on litigation style proceedings that increase contention and make inconsistent use of precedent. There is no



apparent limitation on the issues raised or on repetition of intervenor arguments. Fairness is limited by the sheer cost of participating. Rare use of settlement procedures assures time consuming procedures. In contrast, most effective regulatory processes have moved to make greater use of expedited procedures for settlement among parties.

### RECOMMENDATIONS:

- The Postal Rate Commission should utilize administrative law judges, on loan through the federal system managed by the Office of Personnel Management, as hearing officers in all formal proceedings. The ALJs should also be used to help develop and manage settlement proceedings, notice and comment proceedings, forums, and other conflict resolution mechanisms used by expedited regulatory processes encouraged by the Negotiated Rule Making Act of 1990. (Examples are given in Chapter VI).

VII. FINDINGS: CONGRESSIONAL INTENT IN THE POSTAL REORGANIZATION ACT WAS THAT THE POSTAL SERVICE AND THE POSTAL RATE COMMISSION WOULD COOPERATE WHILE THE PRC PROVIDED CHECKS IN THE REVIEW PROCESS. THE CONTENTION BETWEEN THE PRC AND THE POSTAL SERVICE BOARD OF GOVERNORS IS OUT OF CONTROL AND NEEDS TO BE TURNED AROUND.

In one of the many court cases that have ensued from the failure of the ratemaking process to settle issues, in 1981 a federal judge stated, " We feel compelled to admonish the Board and the PRC to obey an implicit command of the Act that they cooperate."<sup>1</sup> Although there have been ups and downs in the relationship in the last decade, for the most part the judge's suggestion was ignored. The contention of the 1990 rate case mirrors the contention of the 1980 rate case. The competition on "turf" issues, which is fueled by long-standing staff disagreements, has prevented both presidentially appointed panels from cooperating

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<sup>1</sup>Newsweek, Inc. v. U.S. Postal Service, 663 F.2d 1186 (1981), at 1205.



to take a longer view of the mandates of the 1970 Act and the health of the U.S. Postal Service.

That relationship must be turned around now, because the Postal Service is at a crossroad; in fact in relation to the Canadian and European postal services it is late reaching the crossroad. The same challenges that faced the PRC and the Board in 1971--to design a new system--face them again, and they must collaborate to meet the challenge. If they do not, they will preside over either a major legislative restructuring or historical decline of the U.S. Postal Service to the ultimate detriment of every citizen with an address.

#### RECOMMENDATIONS:

- The joint task force described in section I above should be organized as soon as possible.
- The Postal Rate Commissioners should shift their priorities from routine litigation to policy and reform, by utilizing administrative law judges as hearing officers and providing for waivers from ex parte rules, so they can take a leading role in reforming the review process in cooperation with the Governors and lead annual reviews (post audit) of rate changes after reforms are instituted.

The relationship between the Governors and the Commission should be balanced. The resources of the Governors need to be strengthened. Timing of rate change should be modified as suggested above so that the Governors do not have to accept recommendations they disagree with because of cash pressures.

- Legislative amendment should provide for decision of the Governors with respect to PRC recommendations by a two-thirds majority, rather than by unanimity, for which we can find no precedents in public bodies and which is not required of the PRC.
- Legislative amendment should eliminate the second round of PRC reconsideration. It adds time and intensifies contention; there is no evidence that it changes any opinions as to fact or policy.
- The PRC should actively promote its rules on standards of conduct so that staff "avoid every situation which may result in an actual or apparent loss of the complete independence and impartiality which is

essential to command the respect and confidence of the American public."<sup>2</sup>

- The Postal Service Board of Governors should regard the PRC as a genuine resource for review of complex decisions.

More detailed recommendations are made throughout the report, highlighted in each chapter. Chapter I is an introduction and summary which can stand alone, and includes a more detailed summary of recommendations. Chapter II describes the technical aspects of the ratemaking process and its financial impacts. Chapter III evaluates the 1990 rate case in terms of flexibility, simplicity, timeliness and fairness. It is backed up by a detailed flow chart provided as Appendix B. Chapter IV looks at some cases and legislative recommendations over the 20-year period. Chapter V summarizes relevant experiences of other organizations--foreign postal services, government corporations, and private firms. Chapter VI describes comparative regulatory frameworks. Chapter VII discusses some of the technological and market factors that will shape the future for the Postal Service; many of these factors are discussed as well in the earlier chapters. Other appendices include a description of the Postal Reorganization Act and related court cases, and a selected bibliography.

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<sup>2</sup>39 CFR 3000.735-101.