

January 24, 2001

ANITA J. BIZZOTTO
VICE PRESIDENT, PRICING AND PRODUCT DESIGN

SUBJECT: Revised Audit Report—Overview of the Postal Ratemaking Process
(Report Number MK-LA-00-002(R))

Attached is a revised copy of our internal report on the Postal Ratemaking Process. The report was revised to update Appendix A, Section I, to reflect the "contingency amounts in rate cases are generally less than five percent of anticipated costs." A copy of the report will be sent to all addressees in the original report. We changed the report number to MK-AR-00-002(R) to distinguish between the original and revised version of the reports.

We appreciate your cooperation in this matter. If you have any questions, please contact Larry Chisley, director, Marketing, or me at (703) 248-2300.

Debra S. Ritt
Assistant Inspector General
for Business Operations

Attachment

cc: W. Ashley Lyons
John R. Gunnels

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SUBJECT: Postal Ratemaking Process
(Report Number MK-LA-00-002(R))

This information report provides a description of the postal ratemaking process (Project Number 99RF005RG000). We conducted this review to obtain background information and to prepare an overview of the ratemaking process. This report will be available on our Internet site.

Results In Brief

The Postal Reorganization Act of 1970 established a postal ratemaking process built around an independent Postal Rate Commission (Commission). The Board of Governors (Board) of the Postal Service proposes new rates to the Postal Rate Commission. The Commission then has ten months to conduct formal hearings and submit an opinion and recommended decision to the Board. The Board may approve, reject, or allow under protest the Commission's recommendations. The act contains certain guidelines to establish postal rates including the requirement that rates be fair and equitable and cover the cost of operating the Postal Service. Since 1971 the Postal Service has requested omnibus rate increases about every three to four years. Appendix A presents an overview of the postal ratemaking process.

Objective, Scope, and Methodology

Our objective was to obtain an understanding of the postal ratemaking process and to prepare a report describing the process. To accomplish our objectives we interviewed major stakeholders involved in the ratemaking process including:

- Postal Service staff from Finance, Law, and Marketing.
- Postal Rate Commission.

- Office of Consumer Advocate, Postal Rate Commission.
- Staff from eight large mailing associations who were active participants in rate cases.

Additionally, we reviewed past ratemaking studies and reports and other historical data. We also reviewed testimony and data from past omnibus rate cases with emphasis on Docket No. R97-1.

**Management
Comments**

We shared this report with the Postal Service to ensure the technical accuracy of the material. We incorporated management's technical comments, where appropriate, and accordingly only included management's letter transmitting their comments in Appendix B.

If you have any questions, please contact Larry Chisley, director, Marketing, at (703) 248-2352 or me at (703) 248-2300.

Debra S. Ritt
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APPENDIX A. POSTAL RATEMAKING RESEARCH

TABLE OF CONTENTS

Section I: Background	5
Section II: Internal Process	10
Section III: External Process	20
Section IV: Prior Ratemaking Studies and Audits	24
Section V: Postal Reform Legislation	27
Section VI: References	29

Section I: Background

Overview

Each rate case can be broken down into two basic issues:

- How much revenue does the Postal Service need to cover its costs?
- Who pays what share of that revenue?

The “how much” issue, known as the revenue requirement, is primarily determined by the Postal Service. The “who pays” involves issues of costing, rate levels, and rate design that are presented to the Postal Rate Commission (Commission).

The Board of Governors¹ (Board) of the Postal Service proposes new rates to the Commission. The rate proposal is submitted in the form of a formal request accompanied by Postal Service testimony and analyses explaining the need for a rate increase and how the various rate proposals were developed. Large rate and classification cases that propose changes to all classes of mail are commonly called omnibus rate cases. Since 1971, the Postal Service has filed an omnibus rate case about every three to four years. During an omnibus rate case the Postal Service must develop rate proposals for all subclasses of domestic mail and all 36 special services. Currently, there are over 4,000 postal rates in effect.

After the Postal Service files the rate proposal, the Commission has ten months to present a recommended decision to the Governors. During those ten months, the Commission conducts open hearings on the proposed rate and classification changes. At these hearings, the Postal Service answers questions from various interested parties such as customers, competitors, and consumer advocates. The interested parties critique the Postal Service’s rate proposals and offer their own alternatives. After considering all evidence, the Commission presents its findings to the Governors in an Opinion and Recommended Decision.

The Governors have several options after they receive the Commission’s recommended decision. They may:

- Approve the recommended decision.
- Reject the recommended decision.
- Allow the recommended decision under protest and seek further review.
- Modify the recommended decision with unanimous written concurrence.

¹ There are nine Governors appointed by the President with the advice and consent of the Senate. Those nine Governors, plus the postmaster general and deputy postmaster general, make up the Board of Governors. While the Board of Governors proposes new rates, the nine Governors alone approve rate and classification changes that are recommended by the Postal Rate Commission.

If the Governors reject the recommended decision they may or may not return the decision to the Commission for reconsideration. If the Governors allow the recommended decision under protest, they can return the decision to the Commission for reconsideration or appeal the decision to the U.S. Court of Appeals. After the Commission's second, or reconsidered decision, the Governors can modify the decision if they determine that the recommended rates will yield insufficient revenue.

History

Prior to the Postal Reorganization Act of 1970, Congress set postal rates by law, with little relationship between the revenue from those rates and the actual cost of operating the postal system. Until the middle of the nineteenth century, rates were based on the number of sheets in a letter and the distance it was traveling. In 1845, rates were based on the weight of the letter and the distance it was going. Beginning in 1863, letter rates became more "uniform," that is, they were based largely on weight, regardless of distance.² Table 1 shows the history of First-Class stamp rates beginning in 1885.³

Table 1. History of First-Class Stamp Rates

Date	Rate*	Percentage Increase
1885	2¢	
1917	3¢	50%
1919	2¢	-33%
1932	3¢	50%
1958	4¢	33%
1963	5¢	25%
1968	6¢	20%
1971	8¢	33%
1974	10¢	25%
1975	13¢	30%
1978	15¢	15%
1981 (March)	18¢	20%
1981 (November)	20¢	11%
1985	22¢	10%
1988	25¢	14%
1991	29¢	16%

² Rate for First-Class letters varied depending on whether the letters were entered at the local office or nonlocal office, and whether the local office had letter carriers or not.

³ History of the United States Postal Service: 1775-1993. Publication 100, U. S. Postal Service, September 1993.

1995	32¢	10%
1999	33¢	3%

*The rate for the first ounce of a First-Class letter. Beginning in 1975, additional ounces have been charged rates lower than the first-ounce rate.

Legislation

The Postal Reorganization Act of 1970 established the basic principles on which postal rates are to be set. The primary requirement is that the Postal Service attains financial "breakeven." That is, postal rates and fees need to provide enough revenues so that total postal revenues and appropriations equals as nearly as practicable the total costs. The financial breakeven requirement has been interpreted by the courts to require breakeven over a period of years. For a rate case, the breakeven requirement is applied for a single prospective year, known as the test year, a fiscal year beginning not more than 24 months subsequent to the filing date of the formal request. The revenue requirement is the total required revenue for the test year. The revenue requirement includes:

- Projected operating costs in the test year.
- An amount to offset prior operating losses.
- A contingency amount.

The first component, projected operating costs, includes all operating expenses, depreciation, and debt service. These estimates are developed by adjusting the most recently reported annual costs called "The Base Year." Annual costs are adjusted to test year levels for anticipated changes in prices paid for labor and other resources, and for the effect on costs of forecasted changes in mail volume, work load, productivity gains, and other programs that could affect annual costs. The second component, prior year loss recovery, is provided to achieve breakeven over the long term. The amount of prior year loss recovery is determined by dividing the accumulated operating loss of the Postal Service by an amortization period to obtain an annual prior year loss recovery figure. In prior rate cases, the requested amortization period has been between seven and nine years. The third component specified in the act is "a reasonable provision for contingencies." This contingency amount is generally **less than** five percent of anticipated costs and provides for the impact of unforeseen events on costs or revenues that might adversely affect the Postal Service.

Ratemaking Criteria of Title 39

Title 39 U.S.C. section 3622(b) and 3623(c) sets out nine factors or criteria to be considered by the Commission when recommending new rates and fees. These criteria, and the abbreviated forms by which they are often referred to, are:

- 3622(b)(1): the establishment and maintenance of a fair and equitable schedule; referred to as "Fairness and Equity."
- 3622(b)(2): the value of mail service actually provided each class or type of mail service to both the sender and recipient, including, but not limited to, the collection, mode of transportation, and priority of delivery; referred to as "Value of Service."
- 3622(b)(3): the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type, plus that portion of all other costs of the Postal Service reasonably assignable to such class or type; referred to as "Attributable Costs."
- 3622(b)(4): the effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters; referred to as "Effect of Rate Increases."
- 3622(b)(5): the available alternative means of sending and receiving letters and other mail matter at reasonable costs; referred to as "Available Alternatives."
- 3622(b)(6): the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service; referred to as "Degree of Preparation."
- 3622(b)(7): simplicity of structure for the entire schedule and simple identifiable relationships between rates or fees charged the various classes of mail for postal services; referred to as "Simplicity."
- 3622(b)(8): the educational, cultural, scientific, and informational value to the recipient of mail matter; referred to as "ECSI."
- 3622(b)(9): such other factors as the Commission deems appropriate; referred to as "Other Factors."

Classification Criteria of Title 39

Thirty-nine U.S.C. section 3623(c) sets out six factors or criteria to be considered by the Commission when making a recommended decision to establish new mail classifications or change existing ones. The six criteria are:

- 3623(c)(1): the establishment and maintenance of a fair and equitable classification system for all mail.

- 3623(c)(2): the relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail.
- 3623(c)(3): the importance of providing classifications with extremely high degrees of reliability and speed of delivery.
- 3623(c)(4): the importance of providing classifications which do not require an extremely high degree of reliability and speed of delivery.
- 3623(c)(5): the desirability of special classifications from the point of view of both the user and of the Postal Service.
- 3623(c)(6): such other factors as the Commission may deem appropriate.

Section II: Internal Process

From a Postal Service perspective there are two parts to the ratemaking process, an internal process and an external process. The internal process refers to the Postal Service decision making and case preparation activities that take place before presenting a rate case to the Postal Rate Commission. The external process, discussed in Section III, refers to the activities that take place after the rate case has been filed with the Commission.

Case Preparation

The ratemaking process begins when postal management projects that current rates will not be adequate to cover costs in future years. The Postal Service Finance Department projects volumes, revenues, and costs to determine at what point, i.e., which year, postal revenues will become insufficient. After determining in which year the financial condition will be unsatisfactory, a revenue requirement for that year is developed. That revenue requirement forms the beginning of the rate case preparation process.

As mentioned above, Finance develops the revenue requirement by forecasting volumes, revenues, and costs. A base year, the most recent year for which cost data are available, is selected and the base year costs are then adjusted using the forecasted volumes, revenues, and cost data. Finance also performs special cost studies to establish the basis for rate discounts. Additionally, Finance supports rate cases by conducting systems activities that involve the continuous collection, processing, and development of cost, volume, revenue, and weight data.

The Marketing Department develops the various postal rates and classifications and develops the specific rate level and rate design proposals. The Law Department writes the formal request for the change in rates and fees and ensures that all documents required by the Commission's Rules of Practice are filed. The Law Department also reviews all testimony and workpapers before they are filed.

Court interpretations of the Postal Reorganization Act have given the Postal Service wide discretion over the timing of rate changes. Because of the ten-month Commission hearings, and the time it takes to implement new rates, a decision to change rates must be made 15-18 months ahead of the desired implementation date. Some strategic factors that affect the Postal Service's decision to change rates include:⁴

- Postal Service performance.
- External events (economy, inflation, and legislation).
- Financial goals and strategies.

⁴ Postal Rates and Rate-making Procedures: Five Presentations. U.S. Postal Service Rates and Classification Department, March 1987.

Revenue Requirement

The Postal Reorganization Act specifies that:

Postal rates and fees shall provide sufficient revenues so that the total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs of the Postal Service.

Courts have interpreted the "as nearly as practicable" to mean that revenues and costs don't have to be balanced each year, but balanced over some period of time undefined by the act. However, within an individual rate case, the breakeven requirement is still expressed as breakeven for a single prospective year, known as the test year. To calculate the revenue requirement the Postal Service:

- Selects a test year (a fiscal year beginning not more than 24 months subsequent to the filing date of the formal request).
- Estimates test year costs by adjusting the most recently reported annual costs.
- Calculates the revenue requirement by taking the estimated test year costs, plus an amount to recover prior losses, plus a contingency amount.

In past omnibus rate cases, the Commission did not materially change the Postal Service's revenue requirement request. Table 2 shows that the largest change occurred in rate case R80-1 when the Commission reduced the Postal Service revenue requirement by 4.1 percent.

Table 2. Revenue Requirement for Ten Omnibus Rate Cases
(Millions)

Rate Case	Postal Service Request	Commission Changes	Final Revenue Requirement	Percentage Change
R71-1	\$9,841	(\$116)	\$9,725	(1.2) %
R74-1	12,241	No change	12,241	-
R76-1	14,171	No change	14,171	-
R77-1	17,642	(97)	17,545	(0.5) %
R80-1	22,963	(949)	22,014	(4.1) %
R84-1	29,339	368	29,707	1.2%
R87-1	38,845	(65)	38,780	(0.2) %
R90-1	48,109	(193)	47,916	(0.4) %
R94-1	54,585	(68)	54,517	(0.1) %
R97-1	61,604	(745)	60,859	(1.2)%

Systems Activities

The Postal Reorganization Act specifies that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class of mail or type of service. To meet this requirement, the Postal Service must determine the revenues, volumes, and costs of each class of mail, subclass, and special service. Postal Service revenue and accounting systems do not provide revenue and cost information down to the subclass and special service level. Therefore, various statistical systems and special studies provide data from which estimates of volumes, revenues, and costs for various categories of mail are developed. In addition to rate case preparation, these cost and volume estimates are used to prepare budgets, conduct studies, measure mail flow and service performance, and assist in determining incentive award programs.⁵

Attributable and Institutional Costs

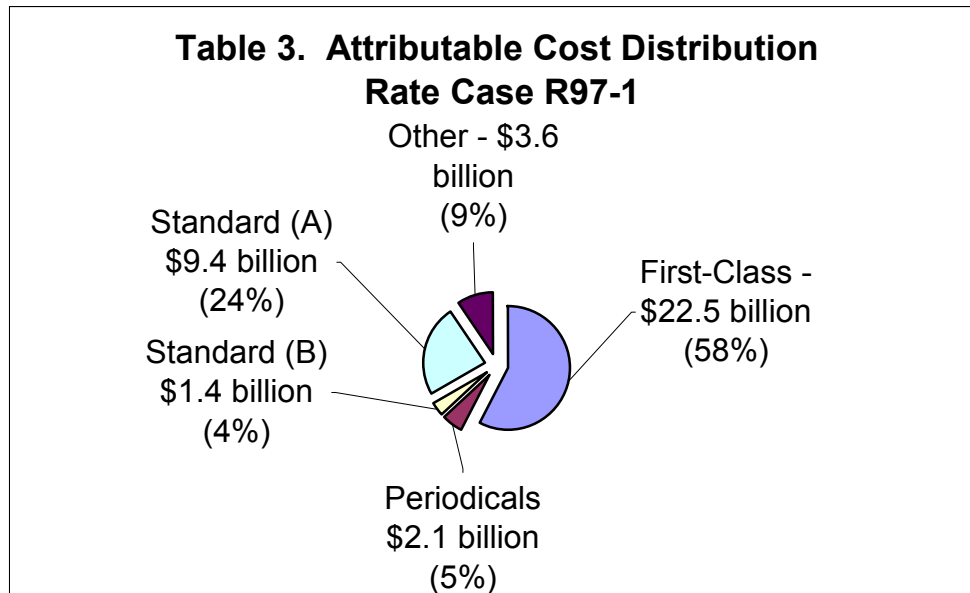
Total Postal Service costs are broken down into attributable and institutional costs. Attributable costs are those costs that can be directly traced to a particular subclass of mail or mail service. Institutional costs are costs that cannot be specifically traced to a subclass of mail or mail service.

Attributable costs can be volume variable costs that fluctuate with mail volume, or specific fixed costs that are not fixed in relation to mail volume but can still be attributed to one particular subclass of mail or service. Almost all attributable costs are volume variable, with only one percent of attributable costs identified as specific fixed costs. This information is used not only to develop proposals for new postal rates, but also to assist in the preparation of budgets, to conduct management studies, and to support management decisions in transportation and operations regarding mail flow and service performance. The data are also used in the Economic Value Added financial management and incentive award program.

Table 3 shows how the Commission allocated attributable costs to the various mail classes in the 1997 omnibus rate case (Docket No. R97-1).⁶

⁵ Data Collection User's Guide for Cost Systems: Handbook F-65. U.S. Postal Service Statistical Policies and Programs Office, July 1998.

⁶ Postal Rate Commission: Functions and Procedures. Postal Rate Commission, May 1999.



Postal Service Costing

The Postal Service uses cost accounting data, together with cost information from data collection systems and special studies, to obtain estimates of the costs attributable to the various mail classes and subclasses. The Postal Service goes through a three-step costing process:

1. Costs are accumulated in the Postal Service system of accounts (general ledger).
2. General ledger costs are allocated to 19 cost segments.
3. Accumulated costs in each cost segment are separated into attributable and institutional costs and the attributable costs are distributed to the various products (at this stage in costing, the institutional costs are left in one lump sum as a single line item, completely independent of subclass).

Step 1: General Ledger Costs. Although the total operating costs of the Postal Service are available from the general ledger accounts, these accounts do not identify how much of the total costs should be attributed to each mail class, subclass, or special service.

Step 2: Cost Segments. The Postal Service takes the general ledger costs and separates them into 19 cost segments. The 19 cost segments are structured along costs for craft activities, work activities, or major functions. The 19 cost segments are:

1. Postmasters
2. Supervisors and Technical Personnel
3. Clerks and Mailhandlers
4. Clerks (CAG K Post Office)

5. City Delivery Carriers (Office Activity)
6. City Delivery Carriers (Street Activity)
7. Vehicle Service Drivers
8. Special Delivery Messengers
9. Rural Carriers
10. Custodial and Maintenance Service
11. Motor Vehicle Service
12. Miscellaneous Operating Costs
13. Purchased Transportation
14. Building Occupancy
15. Supplies and Services
16. Research and Development
17. Headquarters, Area, Corporate-wide Personnel Costs
18. Equipment Maintenance and Management Training Support
19. Depreciation, Write-Offs, Claims and Interest

The 19 cost segments are further broken down into smaller cost elements known as cost components. For example, cost segment number one, postmasters, is broken down into two cost components:

- Executive and Administrative Schedule 23 and below.
- Executive and Administrative Schedule 24 and above.

Step 3: Cost Distribution. The costs within each cost segment are broken down into attributable and institutional costs. The attributable costs are then allocated to the various mail classes, subclasses, or special services. Postal Service accounting systems do not provide cost information for each class, subclass, or special service. Therefore, the Postal Service uses statistical sampling systems to estimate what portion of attributable costs in each cost segment will be allocated to the various mail classes, subclasses, and special services. Institutional costs are not allocated across the various mail classes and services; the institutional cost burden is distributed across all mail classes and services to raise enough revenue to cover these costs. This process is discussed in the Rate Level section (p. 17).

The Postal Service uses information from five major statistical sampling systems to estimate mail volume and weight and to estimate what portion of the attributable costs in each cost segment will be allocated to the various mail classes, subclasses and services. In addition, special studies are conducted to supplement the information from the major sampling systems. In simplest terms, some of the various statistical cost sampling systems estimate, for example, what percentages of time employees spend handling various classes and subclasses of mail. Those estimates are then used to allocate the employee labor costs to the various mail classes and subclasses.

Statistical Sampling Systems

There are five primary data collection systems used to estimate mail revenues, volumes, and costs for domestic mail. One of the systems, the Revenue, Pieces, and Weight system is used to estimate mail revenue, volume, and weight. The Carrier Cost System and the In-Office Cost System are used to estimate mail labor costs. The Transportation Cost System is used to estimate transportation costs. A fifth system, the Origin-Destination Information System provides some service performance data and limited information on the shape of mailpieces.

The Statistical Policies and Programs office at Postal Service Finance administers the statistical programs. As of August 1998, there were 87 statistical program coordinators, 88 statistical program specialists, and 953 full-time data collection technicians located around the nation who conduct statistical tests.⁷

Mail Revenue and Volume

The Revenue, Pieces, and Weight Domestic Probability system uses probability-sampling techniques to measure the characteristics of the total mail volume by examining (sampling) a small fraction of that volume. Special emphasis is placed on collecting revenue, volume, and weight estimates for First-Class, Priority Mail, Standard Mail (B), and special service mail.⁸ The sampling systems focus on these categories because they have a high proportion of single-piece mail that cannot be measured through other existing systems. For example, information on Express Mail volume comes from the Electronic Marketing Reporting System, which gives a census (as opposed to a sample) of Express Mail pieces, revenue, and weight. Also, the PERMIT system collects census information on mail volume, revenue, and weight of pieces entered using PERMIT and mailing statements. The Electronic Marketing Reporting System data and the mailing statement data is combined with Revenue, Pieces, and Weight Domestic Probability system sample data to produce the total Revenue, Pieces, and Weight report.

Delivery Labor Costs

The Postal Service uses the Carrier Cost System to allocate delivery labor costs across all relevant mail categories. This cost system uses two types of tests to estimate mail characteristics on different routes and at different times of the year for each category of mail. This determines the portion of total delivery costs that is attributable to each mail class, subclass, and special service. A city carrier route test measures mail characteristics on city routes while a rural carrier route test measures mail

⁷ Statistical Programs. U.S. Postal Service Statistical Policies and Programs Office, August 1998.

⁸ Statistical Programs. U.S. Postal Service Statistical Policies and Programs Office, August 1998.

characteristics on rural routes. For both tests, randomly selected routes are sampled throughout the year and mail volume and mail characteristics are recorded.⁹

Transportation Costs

The Postal Service uses the Transportation Cost System to allocate transportation costs to various classes and subclasses of mail. The Transportation Cost System uses five separate sampling systems to gather data on highway, rail, Amtrak, passenger air, and network air. Essentially, these sampling systems involve opening the trucks, trains, or planes and recording what mail is on board.¹⁰

Personnel Costs

The In-Office Cost System is designed to supplement the payroll accounting system cost data by sampling employees at randomly selected points in time.

Postal Service payroll accounting systems cannot identify labor costs by subclass of mail because employees may be simultaneously processing more than one subclass in some operations. When an employee is sampled, the activity of the employee at that point in time is recorded as well as the characteristics of any mail the employee is handling. Employees from each of five craft groups are sampled: (1) clerks, (2) mailhandlers, (3) city carriers, (4) special delivery messengers, and (5) supervisors. The results of the In-Office Cost System sampling are applied to labor costs from the accounting system to obtain estimates of labor costs by craft and function.

Special Studies

In addition to the major data collection systems, the Postal Service uses a number of special studies to augment the basic costing information. For example, determining how to allocate costs of vehicle service drivers. Also, the special studies are used to estimate cost avoidances associated with mailer worksharing activity (for instance, how much does presorting save the Postal Service in mail processing costs). The need for a special study is often identified during rate cases. As of June 1999, there were 45 special studies underway for the next omnibus rate case.

Cost Allocation in Docket No. R97-1

In Docket No. R97-1, the Postal Service identified just over 60 percent of Postal Service costs as being attributable. They identified the remaining costs as institutional costs that have to be spread over all mail services. Attributing costs to the individual mail classes, subclasses, and services is the complicated and often controversial part of the process. During Commission proceedings users of a particular mail service almost

⁹ Data Collection User's Guide for Cost Systems: Handbook F-65. U.S. Postal Service Statistical Policies and Programs Office, July 1998.

¹⁰ Data Collection User's Guide for Cost Systems: Handbook F-65. U.S. Postal Service Statistical Policies and Programs Office, July 1998.

always take the position that the Postal Service has over-attributed costs to their mail category. At the same time, Postal Service competitors take the opposite position – that the Postal Service has not attributed enough costs to that particular mail service.

Revenue requirement issues must be addressed before attributable and institutional costs can be developed. The test year must be selected and changes in cost levels and other cost-driving features must be estimated before costs attributable to the classes of mail can be developed for the test year. Once attributable costs for the test year are determined, rate level decisions must be made. The rate level decisions must set rate levels above the attributable cost levels to yield the required total revenue.

After the revenue requirement has been calculated; and mail volume, revenue, and costs have been estimated and attributed to each mail class and service; the Postal Service must set rate levels and develop rate designs to recover institutional costs of the Postal Service. These institutional costs are just under 40 percent of the total Postal Service costs.

Rate Levels

A rate level is the cost coverage for a class or subclass of mail; rate design is the process of developing each of the particular rate elements within a subclass or class of mail. For instance, the rate design process produces a rate for each zone and weight increment in Priority Mail, and a set of discounts for different levels of presorting in Periodicals.

In postal ratemaking, the term cost coverage is often used to describe rate level decisions. Cost coverage is determined by dividing the revenue in a subclass by attributable costs. In the following illustration, the total average cost coverage necessary to completely cover all costs - attributable and institutional - is 159 percent.

Total Cost Coverage			
Revenue Requirements	Institutional Costs	$\frac{\text{Revenue Requirements}}{\text{Attributable Costs}} = \text{Cost Coverage}$	= Cost
	37 %		
Revenue Requirements	Attributable Costs	Or	
	63 %		
		$\frac{100}{63} = 159 \%$	

Each subclass must cover its full attributable cost. That means that it must have a minimum cost coverage of 100 percent. In the above illustration, while the average cost

coverage must be 159 percent in order to breakeven, most of the individual subclass cost coverages will be higher or lower than 159 percent.

Although rate level decisions are based in theory and analysis, setting rate levels is inherently a judgmental process. However, rate level decisions are primarily influenced by three major sets of factors:¹¹

- Historical interpretation.
- Statutory requirements in the Postal Reorganization Act.
- Practical or business constraints.

The rate levels from the last rate case provide a starting point of reference to determine future rate levels. Generally, large increases/decreases from the most recent rate case are avoided.

Rate levels are developed based on the statutory requirements outlined in the Postal Reorganization Act. Additionally, Congress has enacted a number of laws that extend free or reduced rate mailings to certain nonprofit and other preferential mailers. For example, the Revenue Forgone Reform Act determines the rate relationship between nonprofit and preferred rate categories and their commercial counterparts.

Practical and business constraints also influence rate level decisions. One important practical constraint involves First-Class Mail rates. First-Class rates are set in whole cents and each one-cent rate increase results in over \$1 billion in revenue. Therefore, each one-cent increase in First-Class Mail drives price increases or decreases in other classes of mail. Another business constraint is the price level for competitive products and services. The prices for competitive products and services can't be too high or sales would suffer.

In the end, rate levels must ultimately be developed and defended explicitly in terms of the nine pricing criteria set out in the Postal Reorganization Act. The point of developing rate levels is to distribute the institutional cost burden fairly to the classes and subclasses of mail. The rate levels determine percentage increase in rates for each subclass. These percentage increases in rates cause changes in the forecasted volumes of mail in each category, depending on the price sensitivity (own-price elasticity) of each mail category. These volume changes then drive changes in both costs and revenues. A set of rate levels must be developed that, after resulting in percentage rate increases that drive volume changes and cause changes in costs and revenues, results in financial breakeven.

¹¹ Postal Rates and Rate-making Procedures: Five Presentations. U.S. Postal Service Rates and Classification Department, March 1987.

Rate Design

Designing rates involves developing a rate structure and determining the specific rates and rate components in that structure. Over 4,000 separate rates must be designed. Rate design activities begin with the attributable cost for each subclass of mail. This cost multiplied by the cost coverage of the subclass yields the revenue required of the subclass. The rates designed for the subclass must allow this required revenue to be realized.

Rate design activities are guided by the statutory requirements of the Postal Reorganization Act. In practice, however, as allowed by the act, the number of factors that may be considered is not clearly limited. The following rate design factors are specifically mentioned in the act:

- Fairness and equity are considered in all rates and in all rate designs. Opinions often differ substantially on how these terms should be interpreted.
- Rate simplicity is an important goal in all mail subclasses. However, since market realities and arguments relating to equity usually lead to complexity rather than simplicity, tradeoffs are always involved.
- The degree of preparation of the mail by the mailer is being recognized more and more.
- The educational, cultural, scientific, and informational value of the mail matter is required to be given special consideration in setting rates for Periodicals and special rate Standard Mail (B).

Other historical rate design factors include constraining the range of percentage increases within a subclass to prevent "rate shock." Also, maintaining rational rate relationships both within a subclass (e.g., the heavier the item, the higher the rate) as well as between subclasses. For example, the Express Mail rate for a weight increment should be higher than the Priority Mail rate for that increment, which should be higher than the Parcel Post rate for that weight increment.

After the Board of Governors approves a rate proposal, activity shifts to the process of presenting a rate request to the Commission. In presenting its rate case, the Postal Service sends to the Commission dozens of pieces of direct testimony, hundreds of library references, and thousands of pages of workpapers and other analyses to support the testimony and library references.

Section III: External Process

Postal Rate Commission

The Postal Rate Commission is an independent agency of the Executive Branch created by the Postal Reorganization Act of 1970 for the primary purpose of setting postal rates. Prior to 1970, Congress established postal rates and most rates were changed infrequently. One of the reasons for the passage of the Postal Reorganization Act was to reduce the continuing losses associated with providing mail services. The act was designed, in part, to have the Postal Service operate in a more businesslike manner and to cover its costs (financial breakeven). Additionally, Congress wanted to ensure that all interested parties had an opportunity to be heard before the Postal Service changed its rates. The President appoints the five Commissioners and designates the Chairman. The Senate confirms members for six-year terms. The Commission operates with a multi-disciplined staff of about 45 individuals trained in law, economics, statistics, and cost accounting.

The Commission has jurisdiction over changes in postal rates, fees, and mail classifications proposed by the Postal Service. Rate and classification proceedings that involve changes in postal rates and fees for all classes of mail and special services and numerous changes in the mail classification system are known as omnibus rate cases. Since the 1970 reorganization, the Commission has issued recommended decisions in 11 omnibus rate cases.

The Commission does not review recommended rates for international mail. Mail originating in the U.S. for delivery abroad pays international mail rates that are established by the Postal Service. The Postal Reorganization Act gives the Postal Service the authority to establish international postal agreements and postal rates. Therefore, the Postal Service does not have to submit, and the Postal Rate Commission does not review, proposed rates for international mail. However, because the Postal Service's cost, volume, and revenue estimates for international mail impacts domestic mail rates, Congress requires the Commission to prepare an annual report on the costs, revenues, and volumes of each international mail product and service.

How the Commission Operates

To ensure that all interested parties had an opportunity to be heard, Congress wrote into the act the requirement that the Commission hold open hearings on the rate and classification proposals. During these hearings all relevant and material evidence must be considered. As a result, the record developed in omnibus rate cases is often huge, involving many costing, pricing, market analysis, and public policy issues. By the second omnibus rate case in 1974, the evidentiary record was becoming unmanageable. Because of a delayed decision in the second omnibus rate case,

during which time the Postal Service suffered significant losses, Congress amended the 1970 act and required the Commission to issue its decision within ten months. This time limit can only be extended if the Postal Service delays the Commission's decision by failing to respond within a reasonable time to any lawful Commission order.

Current Procedures

The Postal Reorganization Act also granted the Commission the authority to establish procedural rules that would promote fairness and timeliness. Currently, the Commission's procedures can be divided into seven stages:¹²

1. The Postal Service's request
2. The Commission's notice
3. The discovery process
4. Commission hearings
5. Initial briefs and reply briefs
6. Oral arguments
7. The Commission's Opinion and Recommended Decision

Most rate and classification cases begin when the Postal Service submits a formal request for proposed new rates and classification changes to the Postal Rate Commission. To support its request the Postal Service provides detailed testimony, cost studies, market research, surveys, and workpapers explaining the revenue requirement; revenue, volume and cost estimates; rate levels; and rate designs.

After the request is filed, the Commission issues a notice, which is published in the Federal Register, notifying interested parties that hearings will be held. Direct notices are also sent to interested parties who participated in recent rate cases.

Discovery is the principal means used by the Commission to develop an evidentiary record on which to base its recommended decision. Because of the 10-month timeframe, Commission procedures are designed to expedite the process while still allowing all relevant evidence to be considered. After the Postal Service files its case, written discovery takes place, followed by public hearings and oral cross-examination of postal witnesses. Then the intervenors file their cases, written discovery on their cases ensues, and then there are public hearings and oral cross-examination of intervenor witnesses. Subsequently, both the Postal Service and intervenors file rebuttal testimony for which there is no written discovery process, only oral cross-examination.

The discovery process allows interested parties to question Postal Service witnesses about their testimony and supporting material. The Commission itself can request information from the Postal Service in the form of Presiding Officer's Information Requests. Additionally, all parties may seek information from the Postal Service as an

¹² Postal Rate Commission: Functions and Procedures. Postal Rate Commission, May 1999.

institution, as opposed to seeking information only from postal witnesses. Under Commission rules there are three types of discovery:

- Interrogatories, or written questions.
- A request for production of documents.
- A request for the admission of relevant facts.

In omnibus rate cases, the initial discovery period for examining the Postal Service's case is generally between 9 and 14 weeks. In recent rate cases the Commission has tried to speed up the process by directing the Postal Service and other interested parties to respond to discovery within 14 days.

The Commission normally holds three stages of public hearings:

- Hearings on the direct evidence the Postal Service submitted with its case. During hearings on direct evidence, Postal Service witnesses are subject to cross-examination by interested parties over a period of three or four weeks.
- Hearings on the evidence interested parties have submitted. The interested parties may submit direct evidence, such as introducing a new proposal, or they may submit evidence rebutting the testimony of the Postal Service.
- Hearings on rebuttal testimony filed by the Postal Service (and interested parties) to rebut the evidence submitted by other interested parties.

Initial briefs are written legal documents filed by the Postal Service and interested parties to support their positions. Reply briefs are written responses to the legal arguments of the Postal Service and other interested parties.

Oral arguments conclude the formal hearings and allow the Postal Service and interested parties an opportunity to highlight key points and issues raised during the proceedings.

After considering the evidence from the hearing record, the Commission presents their findings and conclusions in an Opinion and Recommended Decision. The Commission weighs all record evidence from both the Postal Service and intervenors and may make substantive changes to the Postal Service's proposals based on evidence that was put on the record during the case. In reaching their decision, the Commission follows ratemaking guidelines included in the Postal Reorganization Act of 1970. Included are requirements that postal rates and fees be fair and equitable and that each type of mail bears the direct and indirect postal costs attributable to that type of mail plus a portion of all other costs of the Postal Service reasonably assignable to that type of mail.

Office of Consumer Advocate

The Office of the Consumer Advocate is an independent office within the Commission and represents the interests of the general public in the Commission proceedings. They are colocated with the Postal Rate Commission and have a small staff of about 15 rate analysts, economists, and attorneys. During a rate case the Office of Consumer Advocate helps develop a complete and accurate hearing record and advocates specific proposals that will benefit the general public.¹³

Intervenors

Intervenors are a diverse group of mailers, Postal Service competitors, and employee organizations that participate in omnibus rate cases. The Office of Consumer Advocate is also considered an intervenor. Additionally, interested individuals representing only themselves can participate as intervenors. During Commission proceedings, postal experts from these organizations thoroughly review and critique Postal Service data and proposals. The individual intervenors have narrow interests-they want to ensure that the rates for the class of mail they use most frequently remain as low as possible. To do so, they often have to defend their class or subclass of mail against attack from other intervenors. In general, the mailers take the position that costs have been over-attributed to their particular class or subclass of mail. Competitors often take the opposite position-that the Postal Service has not attributed enough costs to its competitive products, primarily its expedited and parcel mail products.

¹³ Role of the OCA at the Postal Rate Commission. Postal Rate Commission Internet Site, Available at <http://www.prc.gov/oca.htm>

Section IV: Prior Ratemaking Studies and Audits

Over the 30-year period since the 1970 Postal Reorganization Act, many studies have proposed changes to the postal ratemaking process. Most of these studies have focused on ratemaking changes to reflect the competitive environment in which the Postal Service operates. Three of the more recent studies are discussed below.

Data Quality Study. In April 1999, A.T. Kearney, Inc., a national consulting firm, completed a two-year study of the quality of data used in postal ratemaking. The study was cosponsored by the Postal Service, Commission, and General Accounting Office (GAO) in response to a congressional request for an independent review of ratemaking data.

The Data Quality Study consists of a 142-page Summary Report and four Technical Reports.

- Technical Report #1: Economic Analysis of Data Quality Issues.
- Technical Report #2: Statistical Analysis of Data Quality Issues.
- Technical Report #3: Simulation Analysis of Data Quality Issue.
- Technical Report #4: Alternative Approaches to Data Collection.

The overall objective of the study was to determine whether the Postal Service "provided sufficiently (1) complete and (2) accurate data for ratemaking, considering the costs involved in providing such data." In general, the study concluded that the quality of data provided by the Postal Service for ratemaking was sufficiently complete and accurate, considering the costs to collect the data. Although the Postal Service does not track or calculate the costs of collecting ratemaking data, the Postal Service estimated the cost for fiscal year 1998 was about \$77.8 million.

The Study makes 47 recommendations on how the Postal Service can improve cost data collected for the following four areas:

- Mail processing.
- Delivery.
- Capital and Support.
- Revenue, Volume, and Weight.

In December 1999, the Postal Service reported that of the 47 study recommendations, they had combined similar and redundant recommendations and identified 37 recommendations. Of the 37 recommendations, 11 recommendations were being implemented, 7 recommendations would be implemented in the long-term, 15 recommendations need further management consideration, and 4 recommendations would not be implemented because they either hurt data quality or depended on changes in operations that were not likely to occur within the relevant planning horizon.

Institute of Public Administration. Because of contention between the Postal Service and the Postal Rate Commission over the 1990 rate case, the Board of Governors contracted with the Institute of Public Administration¹⁴ to study the ratemaking process. In October 1991, the Institute presented a report to the Board of Governors that concluded the ratemaking process adversely affected the Postal Service's ability to serve the public and compete in a changing competitive environment. They reported that the process had become too cumbersome, rigid, and narrow. The Institute of Public Administration recommended that the Board of Governors and the Commission establish a joint task force to draft a comprehensive revision of rules governing ratemaking and classification. Among other suggestions, the institute recommended that:

- Omnibus rate cases should be based on a four-year financial plan, rather than on a one-year test period.
- The Postal Service and Commission should agree on categories of information to be submitted with the plan, which should become regular products of budgeting and information systems.

These suggestions were not implemented.

Joint Task Force on Postal Ratemaking. In response to the Institute of Public Administration's report, the Postal Service and the Postal Rate Commission established a joint task force to examine ratemaking and to provide proposals for new procedures. In June 1992, the Joint Task Force issued a report, which called for more flexibility in pricing by the Postal Service and a continuing need for greater accountability in postal financial performance. None of the Task Force's recommendations were fully implemented. Some of the key recommendations included:

- A four-year ratemaking cycle.
- A "rate band approach for competitive postal products that would allow the Postal Service to set rates within this band to meet competitive pressures."
- Recommendations to help the Postal Service experiment with new product lines and changes in service (the Postal Rate Commission adopted some of these recommendations into their rulemaking procedures).

General Accounting Office. The GAO has conducted a series of audits focusing on postal ratemaking. Their most recent effort was a 1995 audit, which summarized past GAO efforts and presented a number of recommendations designed to improve the ratemaking process.¹⁵ In general, past GAO audits have concluded that to better compete in competitive markets, the Postal Service needs more flexibility in setting postal rates and these rates should be based to a greater extent on economic

¹⁴ A private, nonprofit organization whose staff members include specialists in public and business administration, finance, political science, and economics.

¹⁵ GAO Report No. GAO/GGD-96-8. U.S. Postal Service: Postal Rate-making in Need of Change, October 15, 1995.

principles. Among other things, GAO found that Congress might have to clarify the 1970 ratemaking criteria because of continuing disagreements between the Postal Service and the Commission.

Section V: Postal Reform Legislation

Currently, two postal reform bills are pending in the U.S. House of Representatives, Committee on Government Reform. H.R. 22, "The Postal Modernization Act of 1999," and H.R. 2535, "The Postal Service Enhancement Act."

House Resolution 22

Under H.R. 22, the Postal Reorganization Act of 1970 would be modified and a new postal rate-setting process would be established. Postal products would be divided into two categories, noncompetitive and competitive mail categories. The Postal Rate Commission would review the placement of new postal products in those categories.

Noncompetitive products would include First-Class Mail and other products for which there are few alternatives to the Postal Service. Rates for noncompetitive products would be under a price cap system that would basically limit rate increases to changes in the Consumer Price Index for All Urban Consumers less an "X" factor reflecting productivity that would be set by the Commission. The Commission would establish the price caps and review them every five years. Once the price caps were established, the Board of Governors could adjust prices within the price caps. The idea behind the price cap system is that it would offer the Postal Service some pricing flexibility while keeping postal rates stable. Also, it would create incentives for Postal Service cost efficiencies since the Postal Service would be able to keep profits they generate as long as rates remain within the Postal Rate Commission imposed caps.

Under H.R. 22, the Board of Governors would have the authority to establish rates for all competitive products. There would be two minimum rate requirements for competitive products. First, rates for each individual competitive product would have to be set high enough to cover both the direct and indirect postal costs attributable to that product. Second, competitive products would annually have to contribute as a group at least an equal percentage of institutional costs, as all noncompetitive and competitive products combined. The purpose of the rule would be to prevent the Postal Service from loading a disproportionate share of costs on the users of noncompetitive mail.

In addition to the current Postal Service fund, a second competitive product fund would be created within the Treasury solely for the revenues and expenditures associated with competitive products. The purpose of this separate fund would be to level the playing field for competitive products and to protect the interests of noncompetitive consumers and taxpayers. Essentially, the Postal Service would operate this fund at its discretion, but the fund would not obtain government loans and could not have access to the Postal Service funds. The fund would begin with an amount, set by the Commission, equal to the net value of assets and liabilities currently used by the Postal Service in providing competitive products. H.R. 22 would also allow the Postal Service to sell

nonpostal products if they were produced by a private law corporation owned by the Postal Service and funded from the Competitive Products Fund.

House Resolution 2535

H.R. 2535 was introduced as an alternative to H.R. 22. It would allow the Postal Service to negotiate service agreements with large-volume mailers. Additionally, H.R. 2535 would allow the Postal Service to establish rates for competitive products and services. The measure would also create a special commission to examine the Postal Service's efficiency and effectiveness.

Section VI: References

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APPENDIX B. MANAGEMENT'S COMMENTS

Anita J. Bizzotto

Chief, Policy, Research, & Statistics Division



June 1, 2000

ROBERT L. EMMONS

SUBJECT: Postal Ratemaking Process

Thank you for the opportunity to review your draft internal report on the Postal Ratemaking process (Project Number 99RF005RG09000). The report does a good job of generally describing the current process of preparing for, proposing, and litigating changes in postal rates, fees, and classifications. The tone of the document seems appropriate, given the subject matter, and the report appears to present a balanced view of the process, reflecting concerns and issues of the Postal Service and the Postal Rate Commission as well as intervenors.

Members of my staff have reviewed your draft report and have recommended some changes. Most of the changes are of a technical nature, suggesting particular changes in wording, for example. The suggested changes are included in the attachment to this letter. Should you have any questions regarding the particular changes, please feel free to contact me or to call Ginny Mayes at (202) 268-2661.

A handwritten signature in black ink, appearing to read "Anita J. Bizzotto".

Anita J. Bizzotto

Attachments