

REGULATION OF COMPETITIVE PRODUCTS

The design for handling competitive products that underlies both the Senate and the House Bills attempts to create a separate Postal Service, with separate assets and costs, and subject to a host of laws, including taxation, in an attempt to create a level playing field between the Postal Service and its competitors in the marketplace. In order to permit the Postal Service to behave like a business in the marketplace, it would be granted the ability to meet marketplace prices and cut deals, just as do their competitors, with the caveat that they could not use revenues from the market-dominant products in order to cross-subsidize competitive products with predatory prices. A major issue that both Bills attempt to deal with is what portion of the institutional costs are to be borne by the competitive products. Currently, and for the immediate future, it seems clear that some 40 percent of postal costs are institutional, that is, they are not caused by any particular postal product, but are common costs, which do not disappear if a product disappears. This is a delicate balancing act: market-dominant products do not want to bear a greater share of institutional costs than is necessary. On the other hand, the market-dominant products do not want to see the Postal Service priced out of the competitive products marketplace because the share of institutional costs currently paid for by those products, some \$2.75 billion, would then be shifted to them. In short, the market-dominant products in an ideal world would like the competitive products to bear the maximum amount of institutional costs they can, without becoming non-competitive in the marketplace.

The original House Bill seemed to have addressed the necessary balancing of all of these interests, requiring the competitive products to bear a "reasonable assignment" of institutional costs. That, by the way, is the test that those products currently meet and continue to meet through the rate-making process. There is, therefore, some history as to what a "reasonably assignable" means.

Unfortunately, the House Bill in mark-up adopted a number of amendments pushed by United Parcel Service that have the inevitable effect of disabling the Postal Service as a competitor. These disabling changes are:

1. Single piece parcels are transferred from the market-dominant to the competitive category. Single piece parcels have historically been a part of the core mission of the Postal Service and universal service, reaffirmed by the Presidential Commission. They also fit the House definition of "market-dominant". On the other hand they tend to be high cost packages that are not sought out by competitors of the Postal Service because they are expensive to handle and are often delivered to remote areas, such as Alaska, where no one else will deliver ground parcels. The inclusion of these single parcels in the competitive category will drive up the average costs of parcels by itself. Another likely result will be to convert the \$100 million of institutional costs incurred for the delivery of single parcels to Alaska into an attributable cost that will have to be absorbed by the package delivery services. That, by itself, could drive some parcel rates into the non-competitive range.
2. The House Bill requires 30 days notice of any rate or class changes to be given to the PRC and to those affected, and, combined with the right to file a complaint on deals, creates the possibility of every change in competitive products being challenged by competitors before the Postal Rate Commission, and the possibility that the change will be suspended pending the outcome of the litigation before the Commission.

The test for whether the Commission will suspend before implementation of a deal is whether there is a "substantial likelihood" that a party will be injured. This substantially deviates from the normal legal test for injunctive relief in every court in the country, which is "irreparable injury", and a likelihood that the complaint will prevail on the merits. Obviously, a competitor would not be complaining if it did not believe and could not show it would be injured, that is, that it might lose some business. This test could so easily be met that suspensions would become the rule rather than the exception.

Those competing in the marketplace will readily understand that it is not possible to compete when you must tell your competitor what your price or service change is going to be and give that competitor an opportunity to block it from becoming effective for a given period of time. It is, of course, an axiom that the Government may not act in secret and must give notice of what it is going to do, with some agency having the opportunity to stop it if that is necessary. However, it contradicts the whole premise behind the separation of the Postal Service into two product groups, with one product group being able to behave as though it were freely operating in the marketplace.

3. Both Bills originally contemplated that the Postal Service, in consultation with a big independent accounting firm, would report to the PRC with recommendations about what accounting procedures should be used to identify and value the assets and liabilities of the Postal Service that were associated with the capital and operating costs incurred by the Service in providing competitive products, and how best to prevent cross-subsidization of such products, as well as how to determine when, if, and how much federal income tax the Postal Service would have to transfer from the competitive products fund to the general fund. Now both Bills substitute the Treasury for the USPS as the body to make such recommendations. Not to disparage the Secretary of Treasury, but that office is a political appointment and is subject to influence, as well as not being familiar with the long history of the Postal Service and its accounting practices. This is the only provision of which we are aware that UPS successfully advocated to the Senate Managers in their amendments, so this is now included in both the House and Senate Bill. Obviously, then, UPS thought this was a crucial amendment to both the Senate and the House Bill, and they were successful.
4. The retention of '403(C), the current provision of law which bars, unless specifically authorized, "any undue or unreasonable discrimination among users of the mails, nor any undue or unreasonable preference to any such user." Originally, the House Bill rescinded '403(C) to allow the Postal Service to have more ratemaking flexibility and to do deals. Because of the pressure brought by FedEx against UPS, there was a compromise in the House that, while retaining '403(C), would allow for volume discounts. There is fuzzy legal precedent that casts some cloud over Negotiated Service Agreements of certain types. It is noteworthy that the Rate Commission, despite that precedent, approved one Negotiated Service Agreement and United Parcel Service did not challenge that deal in court. Whatever the merits of the continued application of '403(C) may be, clearly it should be limited to market-dominant products. It is the very essence of competition to do a deal for one customer and not the other, and to let neither of them know. The Senate Bill is silent on '403(C), thereby retaining it, without the House exception.

The Senate Bill, other than including the one UPS amendment with respect to the Secretary of Treasury, does not overtly include UPS language. However, it does pose problems with respect to the guidance and direction to the Postal Regulatory Commission in determining

what kind of share of institutional costs the competitive products should bear. The Senate Bill says that, as an "objective", there should be an "equitable" allocation, between the market-dominant and competitive products, of institutional costs; and it further says that competitive products shall collectively bear "their share" of institutional costs. On the other hand, for market-dominant products, the Senate Bill says that consideration should be given to a "reasonably assignable" share of institutional costs. The different treatment for institutional costs between the two product groups is troubling because no one knows what "their share" means; if it means the same percentage share as the market-dominant group, that would simply price USPS out of the market.

RATE REGULATION OF MARKET-DOMINANT PRODUCTS

The Senate and House Bills still contain significant differences in the manner in which the Postal Service would be able to adjust rates and classes for market-dominant products, and the role the Regulatory Commission (PRC) would play in that process. The Senate Bill requires the PRC, within 12 months of enactment, by regulation to establish a modern system for regulating rates and classes. The House Bill would allow the PRC 24 months to establish the system. Both Bills define similar "Objectives" to be achieved in the system, although the Senate version adds new "Objectives" of pricing to promote intelligent mail and to encourage mailing in non-peak periods.

Both Bills also provide that, in establishing the new system, the PRC will take into account some "factors", which factors are in virtually identical terms the ratemaking criteria in the current law. However, the Senate Bill contains one deviation from the House Bill which could be critical. Factor 3 in the Senate Bill says the PRC must consider a "requirement" that all rates cover costs, both attributable and those other costs reasonably assignable (as does the current law). This could be read by the PRC to require it to impose a cost-of-service test on all rates, negating the benefits of a rate cap regime, and crippling USPS flexibility. In effect, it could impose a cost floor to rates, as well as a cap on increases. This change was requested by the so-called Walker Coalition, and became a Senate Managers' Amendment, obviously at their behest. For what it's worth, USPS professes not to be concerned about this change.

An even more significant difference between the Senate and the House Bill is that the Senate provision says the PRC must set an annual limitation on the percentage changes in rates based on inflation using an index of the PRC's choosing, including, the Employment Cost Index. And the system must establish a schedule whereby rates, when necessary, would change at regular intervals by predictable amounts. The House version, on the other hand, would allow the PRC to choose a system which could include one or more of the following: price caps, revenue targets, or other forms of incentive regulation; cost of service regulation; or any other form of regulation consistent with the "Objectives" and "factors." However, the House goes on to say that the PRC will not permit the average rate in any subclass of mail to increase at an annual rate greater than the comparable increase in the CPI, unless the Commission has determined, after a hearing, that the greater increase is reasonable, equitable and necessary.

The Senate Bill provides that 45 days before the implementation of any rate adjustments the Service would provide public notice with an opportunity for review by the PRC. There is no comparable notice period in the House Bill.

The Senate Bill has an exigency provision which would allow for procedures whereby rates could be adjusted on an expedited basis "due to unexpected and extraordinary circumstances." In effect, there is a comparable provision of sorts in the House Bill because it does allow the Postal Service to exceed the CPI cap if it is justified at a hearing before the Commission.

AUTHORIZATION OF NEGOTIATED SERVICE AGREEMENTS

The Senate Bill explicitly authorizes Negotiated Service Agreements (NSA=s) and spells out the conditions under which they can be implemented. The House Bill does not explicitly treat with the subject. In effect, the House would leave it to the PRC to devise the requirements to be met for the Postal Service to do NSA=s. In theory, under the House Bill, this would only apply to market-dominant products. The Senate Bill effectively adopts the current Postal Rate Commission regulations for seeking approval of an NSA and spells out the evidentiary requirements. The virtue of the Senate Bill is that it would not require an actual hearing and approval by the Postal Rate Commission; rather, it simply spells out the burden that the Postal Service itself should undertake in order to do a deal which, upon complaint, could be inspected by the Rate Commission and terminated if it were in violation of these regulations. That is actually a big deal. Not having to run the traps and go through a year long proceeding at the Rate Commission is a very important distinction. On the other hand, the House Bill, by remaining silent on the subject, with one exception, opens the possibility that a future PRC could have more lenient requirements for the Postal Service to do such deals. The one caveat is that, in both Bills, '403(C) continues to apply, and there remains the argument to be made that, despite the precedent of one approved NSA, they generally run a foul of '403(C).

The Newspapers have been rigorous opponents of NSA=s, and fought them fought legally and substantively in the Capital One NSA case before the Rate Commission. They have managed to convince several senators that NSAs victimize small and individual mailers. There is the potential of a floor amendment to try to make NSA=s unlawful or severely circumscribe them. In fact, of course, under the PRC regulations, now extant, and which the Senate Bill would codify, an NSA cannot be done unless the net effect is either neutral toward or beneficial to all other mailers. Thus, while small mailers or individuals, needless to say, cannot get an NSA, the fact that there are NSA=s executed should at worst be neutral to them in terms of their rates, and more likely help mitigate their own rate increases.

CSRS ESCROW PROVISIONS AND THE CSRS MILITARY SERVICE COSTS

Both Bills establish a Postal Service Retiree Health Benefits Fund that will be used to pre-fund retiree health costs. The surplus resulting from the transfer of the military service costs back to the Treasury will be placed in this new account (about \$18 billion). In addition to that, both Bills require the Service to deposit into that account a payment representing the pre-funding of retiree health care costs that its employees earned in the previous year (about \$2.3 billion in 2006), and a separate payment of interest on the unfunded retiree healthcare obligation (about \$2.8 billion in 2006). Both Bills reject the Postal Service's preferred approach which would not include making any annual principal payments into the fund to liquidate the unfunded obligation (about \$45 billion); but rather require that the Service begin to reduce that unfunded obligations by making principal payments each year. The difference between the two Bills is in the length of the term over which these principal repayments are made. For purely technical reasons, the amount that the House Bill would require to be paid in the years 2006 B 2008 is one billion less, but a larger amount thereafter. This matter is extremely complex, but the bottom line is that, so far as the next rate case is concerned, one can assume that the Senate version of the Bill would impose an additional billion dollars of expense to be recovered in the next rate case. Apart from that, it is likely that the Senate Bill, at least over the intermediate term future, is a more rational and beneficial approach to pre-funding this obligation. I have been given to understand that efforts are underway to smooth the differences so that the short term benefits of the House Bill can be achieved in terms of the next rate case, with the longer term benefits of the Senate Bill.

There is also a timing "glitch", which the Postal Service believes that it will be able to take care of through friendly amendments, at least in the Senate. To simplify, it is a question of the timing of when the Postal Service receives the funds and when they must disburse during fiscal year 2006. However, that could have a severe billion dollar consequence if it is not fixed.

It is also well to bear in mind that, if no legislation passes, then the Postal Service will have to pay into the escrow the CSRS savings, as well as \$1 billion of military retiree costs. That by itself is estimated to add an additional 5.4 percent increase to whatever the rate increase will otherwise be in the next rate case. Whereas, it is anticipated that the House version of the Bill would produce by itself only a 2.4 percent increase, and the Senate version a 4 percent increase.

	Senate Bill B S. 2468	House Bill B H. 4341
1.	Escrow Provisions B different	Escrow Provisions B different B lower rates in 2006 case by \$1 billion
2.	Workshare language - adopts House	Workshare language; 4 years duration; no 5 th exception
3.	Rate regulation of Market-Dominant; can choose cap; but cost of service Arequired" - New Aobjective" - pricing to promote intelligent mail and encourage mailing in non-peak periods	CPI requirement; cost of service regime not required, but allowed - No
4.	Competitive Products - Added House language on study to apply other laws - Treasury recommends the accounting practices (change to House version) - Institutional costs B Aequitable" allocation between MD & Comp. Atheir share" B Acollectively" Areasonable assignable" for market-dominant - Keeps '403(C) No deals ?	Competitive Products - Study - Same - ACollectively make a reasonable contribution" Keeps '403(C) but allows volume discounts
	No	15 day notice for deals and PRC can suspend on Complaint
	No	Single parcels shifted to competitive category would shift \$100 million Alaska by-pass costs to parcels out of institutional. Can=t switch existing products to other category without notice to Congress and one year wait
	No	ASubstantial likelihood" test for suspension of rates not of general applicability" 15 day notice.
5.	NSA=s B authorizes USPS to do them B adopts PRC standards BUT B don=t have to have a Hearing and approval by PRC BUT PRC could cancel or suspend if there=s a valid Complaint	No B but the power to suspend A deals" (NSAs) for competitive products upon Complaint; '403(C) applies
6.	Processing and Distribution Network Study	No
7.	Workers Compensation Disability Pay Altered	No
8	No	Bonus program can exceed cap if Aprogram" approved by PRC '406, p.74

WORKSHARE DISCOUNTS AND COST AVOIDANCE

The Senate Bill now contains the same provisions as the House Bill on the conditions under which workshare discounts can exceed 100 percent of the costs avoided. Given the fact that there are currently a number of discounts, both in First and in Standard, that exceed 100 percent of the cost avoidance from worksharing, for a variety of reasons, their elimination or phasing out would have serious financial consequences to those mailers. To recap, the Postal Regulatory Commission (PRC) is to issue regulations for workshare discounts that ensure such discounts do not exceed the costs avoided as a result unless one of four conditions prevail:

1. If a discount is associated with a new or a changed postal service and is necessary, in order to induce the mailers to change their behavior, so as to further the economic efficiency of the Postal Service, then such discounts may be in effect for a period not to exceed 4 years;
2. If a reduction in an existing discount would, because of a loss of volume from that category of mail, reduce the contributions to institutional costs of the Postal Service, thus resulting in a further increase in rates paid by mailers not able to take advantage of the discount; or if the reduction would impede the efficient operation of the Postal Service;" (This could become an important exception)
3. If the excessive discount is necessary in order to avoid rate shock to mailers, so long as that excess discount is phased out over time; and
4. If the discount is provided in connection with mail matter with educational, cultural, or scientific value, that is, periodicals and books.