



## ***Association for Postal Commerce***

1901 N. Fort Myer Dr., Ste. 401 • Arlington, VA 22209-1609 • Ph: +1 703 524 0096 • Fax: +1 703 524 1871 • Web: <http://postcom.org>

### **POSTAL COSTING: THE CENTERSTONE TO POSTAL REFORM**

When it comes to designing a postal legislative reform proposal, I suppose there are many ways in which one could begin the task. One of the problems that have plagued past years' legislative drafting has been the pressure to try to satisfy the demands of all the affected constituents without a coherent perspective of what kind of change a reform bill is meant to precipitate. In the past, I've written about the need to "correct" the incentives that underlie the legislative and regulatory framework of the postal system to ensure that behaviors will be redirected in a way that fosters a more rational, business-like outcome. In fact, if reform fails to rectify these incentives, postal reform may achieve some short-term benefits, but soon will prove to be a long-term failure.

The key question to the designing any future postal legislation is "where to begin?" While there may be several ways to address this challenge, I'd like to offer you one particular perspective.

When it comes to the customers of the Postal Service, "life" usually begins and ends with postal rates. While customers *are* concerned about quality of service, universal service, and the like, the fact remains that if the prices charged for the services received do not compare favorably with other methods of communicating and transacting business, mail will come out on the short end.

Under the current regulatory scheme of things, ratemaking centers on what is called the "subclass" level, i.e., a grouping of mail that receives the same service level and has similar operational and market-demand characteristics. First-Class, as an example, has two subclasses (one for letters, cards, and flats, and the other for Priority Mail) and so does Standard Mail (one for Standard Regular and one for Enhanced Carrier Route).

Subclass-centered ratemaking begins by determining those activities that are "caused" by any grouping of mail. For example, most of the mail that is in streetside collection boxes is First-Class Mail, consequently, it can be said that the cost of collection box services is largely attributable to First-Class Mail. By contrast, most of the mail processed in Bulk Mail Centers is Standard Mail, consequently, a significant portion of BMC operation costs can be said to be attributable to Standard Mail. The Postal Service and the Postal Rate Commission do similarly with other subclasses and services.

All postal costs, however, cannot be traced back to any particular class of mail. For instance, no one class is considered the "cause" of the Postmaster General's salary. His salary and many other non-attributable costs are considered a cost of operating the Postal Service as an institution. In postal jargon, these are referred to as institutional costs, part of the USPS' overhead.

By law, the rates charged to all subclasses of mail must be sufficient to recover not only attributable costs, but also "a fair share" of the nonattributable, institutional costs. This "fair share" contribution is defined as a percentage *mark-up* above an attributable cost base. A markup of 150% reflects a 50% addition to the subclass' attributable cost base. The *base rate* for a subclass is derived, then, when this markup is translated into dollars and cents. Under the current scheme of things, worksharing by mailers is reflected as a discount off the base rate. The discount is calculated on the basis of costs the Postal Service avoids ("saves") from the mailer's effort.

For many years, this process of ratemaking worked satisfactorily. In the early years, worksharing was minimal, and market-demand differences were not very discernible. Over the years since Reorganization's enactment, however, mailer worksharing has grown significantly. So also has the complexity of determining the full measure of its *avoided* costs. To complicate things more, the operational and market-demand characteristics within many subclasses have become differentiated. A subclass that formerly could be said to be "homogeneous" now evidences considerably "heterogeneity." Consequently, economically-rational ratemaking has become a thornier exercise. Indeed, in many respects, the "homogeneity" of some subclasses is nothing more than a regulatory fiction that has resulted in a rate structure that serves neither the best interests of the Postal Service nor its customers.

The Postal Service *has* benefitted from mailer worksharing. This fact was reaffirmed by the President's Commission on the Postal Service and the General Account Office. Worksharing has permitted the USPS to offer more economically attractive rates at a time when its own operational costs had grown.

For worksharing to work, though, the discounts the Postal Service is willing to provide must *exceed* the cost the mailer must expend on worksharing. When discounts are insufficient, worksharing doesn't occur. Within the current legislative and regulatory scheme of things, postal executives have to balance the disincentives of risking "giving away the store," and the incentives ("rewards") designed to enhance mail's value. In recent years, the fear of disincentives has overshadowed any potential benefits. Consequently, postal management has tended to be stingy with worksharing discounts--even to the point of adopting "discounts" that discourage the kind of worksharing that was meant to be stimulated. Today, base subclass costs are artificially inflated by aggregations of mail that are not homogeneous.

For postal reform to be a success, the "incentives" that flow from any subsequent postal rate design must precipitate acceptable and rational economic behaviors. The most logical course to such a transformation would require a ratemaking structure based on actual costs associated with the resources that are consumed to provide services at various levels (or "access points") within the postal network. Ratemaking should be grounded what a mailer should be required to pay for those resources (and only those resources) that are associated with the the services they consume.

For example, within the Standard Mail Class, mail can be entered at an origin bulk mail acceptance facility, an origin bulk mail center, an origin sectional center facility, a destination bulk mail center, a destination sectional center facility, or a destination delivery unit. Mail entered at an origin point will require considerably more in the way of processing and transportation than mail entered at some destination point. Consequently, if a mailer chooses to forgo postal transportation and mail processing services, transports his mail to a destination delivery unit, and prepares his mail in a manner that requires nothing more than delivery service, his rate should be based on actual mail delivery costs, and not the costs of other services he did not use. By reorganizing ratemaking in this manner, one should expect to find that the rates associated with mail that is prepared in carrier-route walk-sequence for area-wide saturation distribution and dropped ship to the facility from which delivery actually takes place will be less than the rates associated with mail that is less-finely workshared.

Under such a scheme of things, instead of "discounting rates down," the Postal Service would "surcharge rates up" by whatever amount is required to fully recover resource costs. Prices then would be set using mark-ups that can be determined at every level of network access. "Bottom-up ratemaking" also would allow the Postal Service to address more satisfactorily some of today's incongruences. For instance, the *real cost* of delivering a one-ounce First-Class ZIP+4 barcoded letter entered at the destination delivery unit is the same as for a one-ounce letter of similarly prepared and entered Standard Mail. You'd never know this because costing in accordance with the finest levels of network access has no place in today's ratemaking process.

A bottom-up approach to postal costing and ratemaking would enhance whatever incentives would be needed to ensure that cost attributions are accurate and complete, and that incentives are sufficient to motivate desired worksharing outcomes. The emphasis would be on making sure rates are accurate and sufficient to yield a reasonable profit at every level. Basing pricing decisions on the hard-to-determine concepts of "fairness" and "equity" could easily be replaced by pricing designed to derive rates set at levels that are *profitable* and commensurate with marketplace realities.

These principles can be built into a legislative proposal without fundamentally displacing the concepts of attributable and institutional costing. These principles also can be reconciled with Congress' current desire to maintain in rates a reflection of the educational, cultural, scientific, and informational value inherent in periodical, library, media, and nonprofit mail.

This framework also can serve as the basis for subsequent provisions that would afford the Postal Service greater postal regulatory flexibility. Bottom-up ratemaking would provide an excellent foundation for *financial transparency* and the determination of mail service performance standards and measurements. An open and transparent method of defining postal costs would provide a third-party regulator, a postal board of directors, and Congress with a rational basis for determining employment-related compensation and rewards and the adequacy of capital investment or strategic plans intended to make prudent use of postal resources to maximize mail service efficiency, quality, and marketplace value.

Redesigning the postal network is one of the key provisions of the Postmaster General's transformation plan, and it figured fairly prominently in the recommendations advanced by the Presidential Commission.

"Realigning" the network, though, assumes an elimination of unnecessary and costly network redundancies. But how can you determine which elements of your network are redundant, if your decisions continue to be based on an anomalous business (rate) structure? How, for instance, can you say that certain facilities and operations are not redundant if you're never structure to encourage more efficient mailer behavior? A rate structure based on network access and profitable prices, however, could make redundancies more apparent as a consequence of the new behaviors mailers would undertake. In a very real sense, network realignment *demand*s a newer ratemaking framework to ensure success.