

BEFORE THE
UNITED STATES OF AMERICA POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-001

Express Mail Rulemaking, 1988

Docket No. RM88-2

BRIEF, IN THE FORM OF COMMENTS, OF
THE STAFF OF THE BUREAU OF ECONOMICS OF THE
FEDERAL TRADE COMMISSION¹
(submitted October 14, 1988)

I. INTRODUCTION

The staff of the Bureau of Economics of the Federal Trade Commission respectfully submits these comments to the Postal Rate Commission (PRC) in the matter of the Express Mail Rulemaking, Docket No. RM88-2. Under procedures proposed by the United States Postal Service (USPS) in this rulemaking,² Express Mail rate changes would be reviewed more rapidly by the PRC, and Express Mail rates could be set as low as "attributable costs," in response to rates set by one or more competitors.³ The USPS believes

¹ These comments represent the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner. Questions about these comments may be addressed to John C. Hilke, Federal Trade Commission, Bureau of Economics, 6th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20580, telephone: (202) 326-3483.

² The new set of rules "would feature automatic intervention of, and service on, interested parties, and issue limitation. Hearings would be held only if required to resolve a genuine issue of material fact, and would be expedited as much as possible, consistent with due process. The rules also provide for expedited issuance of a recommended decision." "Petition of the United States Postal Service for a Rulemaking to Establish a New Procedure for Adjusting Rates for Express Mail Service between Omnibus Rate Cases," filed April 29, 1988, pp. 8-9.

³ Conceptually, the attributable costs of a particular class of mail service include all costs that occur solely because that class of service is offered. See Opinion and Recommended Decision of the United States of

that it is not an effective competitor in expedited mail service because it currently cannot match competitors' prices in a timely manner.

The PRC has invited views through a notice published in the Federal Register⁴ and has established a schedule for receiving comments⁵ concerning the appropriateness of accelerated rate review and the optimal form of any such review.

Our analysis leads us to favor granting accelerated review of proposed Express Mail rate changes as an integral part of reducing rate regulation for

America Postal Rate Commission (Docket No. R87-1), Vol. 1., Washington, D.C.: PRC, 1988, pp. 96-107. The requirement that rates at least be set to cover attributable costs for each class of mail is contained in Section 3622(b)(3) of the 1970 postal reforms. It requires "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 [.]"

Under the USPS's proposal, the maximum rates for Express Mail would continue to be the rates set through the most recent omnibus rate hearings, held in 1987. Petition of the USPS to the PRC (Docket No. RM88-2), p. 9. The rationale for setting maximum rates for Express Mail, despite the large number of private competitors, is that some individual consumers may have limited alternatives to Express Mail and therefore the USPS may have market power with respect to these consumers. Because the network of post offices accepting express mail is more extensive than the network of offices of private firms (approximately 26,000 out of 29,000 post offices accept Express Mail), consumers' transportation costs to reach an Express Mail office are often less than costs to reach offices of competing firms. Consequently, if Express Mail prices rose significantly, some consumers might not be able to economically turn to other suppliers and might have to pay the higher price or forego the service entirely. Opinion and Recommended Decision of the United States of America Postal Rate Commission (Docket No. R87-1), Vol. 1., Washington, D.C.: PRC, 1988, p. 755.

⁴ Federal Register 53:122 (June 24, 1988), p. 23,776.

⁵ Presiding Officer's Ruling Establishing Procedural Schedule, Appendix A (RM88-2/1), dated July 11, 1988.

both private and public suppliers of expedited mail service.⁶ Currently, both the USPS and private firms in the expedited mail industry are restricted by rate regulations. Rates for Express Mail are established after extensive review by the PRC and approval by the USPS's Board of Governors. Express Mail rates cannot be revised to respond to changes in competitors' prices or to changes in costs without what it regards as lengthy and extensive hearings. Minimum rates for private firms are set by postal service regulations governing exemptions to the private express statutes.⁷

Both economic theory and experience indicate that competitive markets provide the best economic performance. Competition provides incentives to improve economic performance, that is, to minimize costs, to improve quality, and to innovate with new goods and services and with new ways of producing goods and services.⁸ Consumers benefit from lower prices, better quality, and a wider variety of services. We concur with the USPS and the PRC that effective competition can provide these same benefits in the expedited mail service industry.⁹ Price regulations that are unnecessary to

⁶ These comments apply strictly to Express Mail and do not necessarily apply to the more general question of rate flexibility in other classes of mail service, where private firms compete with the USPS, or to questions concerning rate regulation of the USPS in general.

⁷ The exemptions are contained in 39 C.F.R. 320.6. The private express statutes are contained in 18 U.S.C., sections 1693-1699. They impose criminal sanctions on private firms that offer letter mail service.

⁸ This is the fundamental economic rationale for markets. See F. M. Scherer, Industrial Market Structure and Economic Performance, 2nd edition, Chicago: Rand McNally, 1980.

⁹ See the testimony of the USPS's economic expert in this rulemaking, Dr. Alfred E. Kahn, p. 27. Also, see Opinion and Recommended Decision of the United States of America Postal Rate Commission (Docket No. R87-1), Vol. 1., Washington, D.C.: PRC, 1988, pp. 96-125.

maintain competition or to correct market failures have generally been found to reduce competition and consumer welfare. Conversely, removing such regulations generally increases competition and improves economic performance.¹⁰ Consequently, we concur with the USPS that reducing rate regulation can increase competition and benefit consumers in the expedited mail industry.¹¹

To spur competition and increase efficiency, we believe that the USPS's proposals should be expanded by the PRC to reduce rate regulation of both Express Mail and private delivery firms. In particular, if the PRC can obtain assurances that the USPS will revise its regulations to reduce the minimum rates that private firms can charge for expedited mail service, we believe that the PRC could safely grant a "zone of discretion" in pricing Express Mail, rather than just an accelerated review process. The upper limit of the zone would be determined through the omnibus rate hearing process; the lower limit would be attributable costs, including the adjustments we propose to account for tax exemptions and subsidies. Price changes within this zone could be made without further review. Reductions in rate regulation for both government and private firms in this industry would, we believe, provide a fair market test for Express Mail and benefit consumers by enhancing the effectiveness of competition.

¹⁰ P. Joskow and N. Rose, "The Effects of Economic Regulation," MIT Department of Economics Working Paper No. 447, April 1987.

¹¹ "Petition of the United States Postal Service for a Rulemaking to Establish a New Procedure for Adjusting Rates for Express Mail Service between Omnibus Rate Cases," filed April 29, 1988, pp. 4-8.

A fair market test can occur only if firms are able to compete without any disadvantages unrelated to the quality and price of services offered in the market.¹² Without a fair market test, Express Mail could develop excessive costs that waste scarce resources because its tax exemptions and government subsidies could insulate it from competition and allow unnecessary costs to arise. Express Mail might also fail to supply services with the combinations of price and quality that consumers prefer because its unrelated advantages would diminish the urgency of adopting these types of innovations. Innovations of competitors would have to be extraordinary to overcome Express Mail's unrelated advantages. All of these effects would harm consumers and waste resources.

Following a brief statement of the expertise of the FTC's staff in postal matters, we discuss, in turn: 1) the rationale for granting accelerated rate review for Express Mail, 2) the potential inefficiency and anticompetitive effects of regulatory relief in pricing Express Mail without providing similar relief for private firms, 3) a necessary adjustment in the calculation of attributable cost, if attributable cost is to be used as a price floor for Express Mail rates, and 4) a "zone of discretion" alternative to accelerated rate review that could provide additional cost savings and benefits for consumers.

¹² The USPS is disadvantaged by regulatory rate inflexibility. Private firms are disadvantaged by minimum rate restrictions and subsidies received by the USPS.

II. FEDERAL TRADE COMMISSION STAFF EXPERTISE

The FTC is an independent regulatory agency responsible for fostering competition and safeguarding the interests of consumers.¹³ The staff of the FTC, upon request by federal, state, and local government bodies, regularly analyzes regulatory and legislative proposals to identify provisions that may alter competition or production costs, or cause other changes in costs or benefits to consumers.

The FTC staff has commented on several previous issues before the PRC, including: 1) use of a single set of rate hearings to establish a series of rate changes;¹⁴ 2) elaboration of competition issues inherent in proposed electronic computer originated mail (E-COM) rate and classification changes;¹⁵ 3) drawbacks to proposed modification of the test period for cost recovery in E-COM;¹⁶ 4) advantages of setting E-COM rates to cover full costs;¹⁷ and 5) costs and benefits of current preferred mail rates.¹⁸

¹³ 15 U.S.C. Section 41 et seq.

¹⁴ PRC Docket No. MR82-3, filed November 4, 1982.

¹⁵ PRC Docket No. R83-1, filed June 1, 1983.

¹⁶ PRC Docket No. R83-1, filed June 16, 1983.

¹⁷ PRC Docket No. R84-1, filed December 23, 1983.

¹⁸ PRC Docket No. SS86-1, filed April 20, 1986. Preferred mail is mail that is granted a rate discount because it is viewed as meritorious. Other types of postal discounts are cost justified. Preferred mail discounts are granted, for example, for educational materials and for mailings of nonprofit organizations. Congress pays the USPS to make these discounts for preferred mail available.

III. THE BENEFITS OF GRANTING ACCELERATED REVIEW OF RATE CHANGES FOR EXPRESS MAIL

Freedom to adjust rates quickly and easily is often an essential element in a competitive market. We believe that this is likely to be the case in the expedited mail industry and we are, therefore, in full agreement with the stated intent of the USPS's proposal, to increase competition in the industry by increasing rate flexibility.¹⁹ To deny this flexibility in an industry may raise operating costs, increase risk, make strategic planning of new facilities, inventory, and staffing requirements more difficult, and encourage predatory conduct. All of these types of efficiency losses occurred in the railroad industry, for example, under cumbersome Interstate Commerce Commission price regulations.²⁰ When only selected participants in a market are bound by price regulations, they are likely to be unable to compete effectively with their rivals, thereby reducing competition in the market generally.

The USPS's proposals should increase rate flexibility and reduce costs for Express Mail by reducing the time and effort required to revise rates, but the proposed procedures would continue to impose significant lags (that may impair the USPS's ability to quickly respond to changing market conditions) and administrative costs.

¹⁹ Testimony of Dr. Alfred E. Kahn, pp. 11-14.

²⁰ See, e.g., Improving Railroad Productivity, Washington, D.C.: The National Commission on Productivity and the Council of Economic Advisors, 1973.

**IV. POTENTIAL COSTS: INEFFICIENCY AND ANTICOMPETITIVE
EFFECTS OF THE USPS'S PROPOSAL**

A. Overview

The USPS's proposal, in our view, poses two significant threats to economic efficiency and competition.²¹ First, while the USPS's proposals would reduce price regulation of Express Mail, they would leave regulatory rate restrictions on private firms unchanged. If competitors were not allowed to match the Postal Service's prices for Express Mail, the USPS's

²¹ We do not claim that the two problems we have identified are the only ones that exist. The PRC may discover other potentially inefficient aspects of the proposed procedures.

We agree with the testimony (page 6) of the USPS's expert witness, Dr. Alfred Kahn, that the appropriateness of granting increased rate flexibility in Express Mail depends initially upon whether the government should be providing Express Mail service at all. Economic efficiency requires that government produce or provide services only when there is reason to believe that private markets will fail to do so adequately. This principle is embodied in government policies that have been in operation since 1955 (Office of Management and Budget Circular A-76 (Revised) August 4, 1983). The presence of vigorous competition from several private for-profit firms is strong evidence that such market failure, if any, is limited. Indeed, the USPS petition in this rulemaking is premised on the assumption that private firms provide vigorous competition. Petition of the USPS to the PRC (Docket RM88-2), p. 5.

One rationale for the USPS's involvement in expedited mail could be economies of scope between Express Mail and statutorily protected (from competition) classes of mail services, particularly first class mail. Dr. Kahn assumes in his written testimony (p. 7) that there are economically compelling economies of scope. Empirical support for this proposition, however, is not definitive, to the best of our knowledge. The Department of Justice is investigating this question. We note that the compelling economies of scope hypothesis is at least partially inconsistent with the fact that the leading expedited delivery firm, Federal Express, has not participated appreciably in other types of delivery services, while some of its less successful rivals have. Competitors and Competition of the U.S. Postal Service 19 (1987), Section II.

proposal could result in a waste of scarce resources, by both the USPS and by private firms, and result in higher prices and reduced options for consumers. Therefore, we favor allowing private firms to match the USPS's price/quality offerings for expedited mail service as a prerequisite to providing the USPS with greater rate flexibility. Second, the attributable cost rate floor for Express Mail, as currently defined, is likely to be less than its real attributable costs.²² The current attributable-cost calculation for Express Mail does not include an adjustment for the value of postal subsidies. These subsidies consist of items such as tax exemptions and employee retirement and medical benefit paid by the U.S. government rather than postal patrons. We believe that attributable cost should be calculated differently in order to establish the minimum rates for Express Mail.²³

B. Interaction between Attributable Cost Pricing and Restrictions on Private Competitors' Pricing if Express Mail Is Priced Close to the "Urgent" Mail Rate Exemption

Private firms are generally forbidden to offer mail service in competition with the USPS, but an exemption is provided for "urgent" mail.²⁴

²² We assume here that properly measured attributable costs are a reasonable substitute for long-run marginal cost.

²³ This would not require any changes in the subsidies received by the USPS or in its tax status. We suggest only that the PRC require the USPS to set the minimum rates for Express Mail as if it did not enjoy these tax exemptions and other subsidies. Reducing the Deficit: Spending and Revenue Options, Washington, D.C.: Congressional Budget Office, 1988, pp. 270-271.

²⁴ 39 CFR 320.6(b) and (c)(1987). In fact, the USPS's regulations have established two criteria for obtaining an urgent letter exemption: a rate exemption, and a "loss of value" exemption. However, petitioners in the most recent omnibus rate hearings maintained that only the rate

The USPS's rate criterion for the urgent mail exemption requires that private firms charge at least \$3 per item, or twice the first class mail rate, whichever is higher.²⁵ The USPS established this set of minimum prices in the apparent belief that private mail services offered at prices higher than these do not threaten demand for statutorily protected classes of mail (e.g., first class mail). Arguably, however, these minimum prices are set unnecessarily high.²⁶ We believe that experience in Great Britain with a much lower exemption rate may be instructive. In Great Britain, the minimum price of one pound (approximately \$1.50) applies to all letters of

criterion provides a practical, clear-cut, and easily demonstrated standard for obtaining an exemption. "Statement of the Air Courier Conference of America to the President's Commission on Privatization," January 28, 1988, p. 4. The loss of value exemption requires that shippers prove to the USPS that the value or usefulness of a shipment will be "lost or greatly diminished" if the shipment is not delivered within certain time limits.

²⁵ 39 CFR 320.6 (c) (1987). This price test was reportedly the subject of considerable controversy when it was adopted. Several government and private commenters, including the Council on Wage and Price Stability, advocated much lower rates for the exemption during the hearings in 1979. "Initial Brief of the Air Courier Conference of America," PRC Docket No. R87-1 (1987), p. 9.

²⁶ For a background discussion, see Privatization: Toward More Effective Government, Report of the President's Commission on Privatization, 1988, pp. 120-121, and "Initial Brief of the Air Courier Conference of America," PRC Docket No. R87-1 (1987), pp. 4-7.

The PRC does not directly review the USPS's criteria for exemptions to the private express statutes, but the PRC has recognized the potential impact of these regulations on competition in the expedited mail industry has amended Express Mail rates proposed by the USPS to accommodate this concern. Further, the PRC has urged the USPS "to re-visit its decision concerning the test for extremely urgent letters in its regulations in light of the changes in the market." Opinion and Recommended Decision of the United States of America Postal Rate Commission (Docket No. R87-1), Vol. 1., Washington, D.C.: PRC, 1988, pp. 749-751.

Proposals before the President's Commission on Privatization recommended establishing the exemption rate at \$1.

any weight.²⁷ There has been no detectable adverse effect on demand for first class mail service resulting from allowing a lower exemption rate.²⁸

The \$3 minimum rate may cause a number of economic inefficiencies. Of direct relevance here is the potential anticompetitive effect.²⁹ Essentially, the USPS regulates competitors' minimum rates, yet Express Mail could effectively be priced below the rates that at least some equally efficient competitors could legally charge. By focusing only on price, the "meeting-competition" provision in the USPS's proposal ignores the effect of

²⁷ The Postal Privilege (Suspension) Order 1981, 1981 No. 1483, Minister of State, Department of Industry, coming into operation on November 7, 1981. The first class letter rate in Great Britain is 18 pence (approximately \$.27).

Canada has also established a considerably lower exemption rate at three times the first class postage on a 50 gram letter of \$.37 Canadian (approximately \$.30). As in Great Britain, no higher minimum rate applies to heavier items. Canada Post Corporation Act, assented April 23, 1981, sections 14 and 15.

²⁸ Report and Accounts 1987-1988, Postal Service of the United Kingdom, 1988, p. 10.

²⁹ Some private firms, particularly entrepreneurs operating small local courier services, believe that they could profitably provide expedited mail service at rates below the rates that they are permitted to charge under the USPS's exemption regulations. On heavier items, many private competitors believe that they can profitably price below the allowed rates. Opinion and Recommended Decision of the United States of America Postal Rate Commission (Docket No. R87-1), Vol. 1., Washington, D.C.: PRC, 1988, p. 749, "Statement of the Air Courier Conference of America to the President's Commission on Privatization," January 28, 1988, pp. 4-5.

If the price floor for private competitors exceeds the costs of private firms, it may create excessive quality-based competition between private competitors. Firms will seek to increase demand for their services by adding amenities until costs approach the level of the price floor. This harms consumers by eliminating services that combine lower prices and fewer amenities, a combination that many consumers may prefer to other alternatives. Costs became inflated in the airline industry, for example, when regulated air fares exceeded minimum costs.

A higher than necessary rate price floor for private firms would also prevent a fair market test of the USPS's Express Mail service.

substitution between price and quality aspects of a service.³⁰ For example, consider an equally efficient private supplier offering a service with fewer features than Express Mail and consequently needing to charge at least \$1 less than Express Mail to attract customers. Assume that the private firm initially charges the legal minimum of \$3 for a one ounce letter and the Express Mail rate is \$4 (\$3 of which is attributable costs). If Express Mail reduces its price to \$3, to "meet" competition, the private firm would be unable to compete, because the USPS's urgent letter rate exemption sets the minimum price for private firms at \$3. Even if the private firm could otherwise reduce its costs and price at \$2, it could not legally do so. In this scenario, consumers would be denied the combination of low prices and minimal service from the private firm that they might have patronized, had the regulated \$3 minimum price been lower.³¹

If even one local competitor was able to qualify for the loss of value exemption,³² it would become exempt from the \$3 price floor facing other private competitors and could price below \$3. Because of prohibitions against the USPS charging different prices for the same service to different

³⁰ The next section describes how government subsidies may similarly distort the effects of Express Mail prices.

³¹ Similarly, entrants without established reputations for performance quality may have to charge less, at least initially, in order to induce consumers to try their service. Pricing by the USPS close to attributable cost, while maintaining a high price floor for private competitors, could effectively preclude new entry by firms that would eventually be equally efficient competitors.

³² See footnote 24 supra.

customers,³³ the USPS might be permitted, under the USPS's proposal, to price below \$3, nation-wide, in response to pricing below \$3 by a private firm in one area. Meanwhile, other private firms in that local area and in other areas would continue to be constrained by the \$3 rule. If this series of events took place, the USPS might be able to monopolize the industry in some areas because of the \$3 rule.³⁴ Of course, the loss of value exemption may have this anticompetitive effect with any price floor. To the extent, however, that the price floor can be lowered without eroding the demand for protected classes of mail, the opportunity for the loss of value exemption and the price floor to interact in this anticompetitive manner is reduced.

Lack of effective competition for Express Mail under either of the conditions above may erode the USPS's incentives to minimize costs, improve quality, and innovate. For example, assume that competitors are required to price above \$3, and that attributable costs for Express Mail are \$2.50, when Express Mail is operated with minimum costs. Under these conditions, excessive attributable costs for Express Mail could rise by \$.50 before competition from other suppliers could halt the build-up of excessive costs for Express Mail.

³³ Section 403(c) of the postal reorganization statute forbids undue or unreasonable discrimination among mailers and undue or unreasonable preference to a mailer. Opinion and Recommended Decision of the United States of America Postal Rate Commission (Docket No. R87-1), Vol. 1., Washington, D.C.: PRC, 1988, p. 747.

³⁴ In the area where the private firm obtained the loss of value exemption, the USPS would share the market with this one competitor if they both priced below \$3. In other areas, the USPS might be able to price below \$3 without facing any competitors allowed to price below \$3. In these areas, the USPS might be able to monopolize expedited mail service.

In summary, the interaction between the regulated price floor governing private firms and the attributable cost price floor applicable to Express Mail creates a potential source of inefficient and anticompetitive pricing that can best be eliminated by allowing competitors to match or beat any price/quality offerings for Express Mail.³⁵ Without this concurrent relaxation of rate regulations on private firms, these firms might not be able to provide a fair market test for Express Mail over a range of prices near the "urgent mail" exemption rate.³⁶ In this range of rates, the "urgent mail" rate exemption regulations could prevent private firms from even matching Express Mail's price/quality offerings. We suggest that the PRC assure that private firms are allowed at least to match price/quality offerings by Express Mail at the same time that the USPS is granted additional flexibility in pricing Express Mail.³⁷ We wish to emphasize that we have not analyzed the question of specific minimum rates necessary to protect statutorily monopolized classes of mail, nor have we addressed the general question of the regulatory necessity of maintaining a minimum rate for private expedited mail services. We suggest only that detailed study of the British and Canadian exemptions, discussed above, could provide useful guidance.

³⁵ This effect will occur even if attributable costs are adjusted as suggested in the next section of these comments, but the effect would be worse without the adjustment in attributable costs.

³⁶ The anticompetitive effect could take place over a range of Express Mail rates above \$3 if Express Mail included many service extras that would force private firms, with fewer extra services, to cease offering such "no frills" service unless they were allowed to price below \$3.

³⁷ An alternative to lowering the price floor of the urgent letter exemption might be to increase the certainty of qualifying for the loss in value exemption.

C. Necessary Adjustments in the Attributable Cost Calculations for Express Mail

Under existing procedures, the prices for Express Mail service are determined during the omnibus postal rate hearing process. Prices are set to recover USPS's calculations of attributable costs, plus a mark-up.³⁸ From an economic perspective, the attributable cost calculated to establish the minimum rates for Express Mail ideally should include all appropriate costs.

The USPS's current calculation of attributable cost excludes some significant costs that should be included. The USPS has several major cost advantages that originate not from its own efficiency, but from its status as a government-owned enterprise. These cost advantages do not involve real resource savings for society, and the minimum price floor for Express Mail service should account for these cost advantages.³⁹ The major cost advantages of this type accorded to the USPS consist of the following: 1) exemption from state and local sales, property, and income taxes; 2) exemption from federal income taxes; 3) access to below-market rates of

³⁸ Previous rate hearings have raised significant questions about the reliability of the allocations. Most criticisms have suggested that the allocations understate costs attributable to Express Mail. Opinion and Recommended Decision of the United States of America Postal Rate Commission (Docket No. R87-1), Vol. 1., Washington, D.C.: PRC, 1988, p. 736.

³⁹ False cost disadvantages of the Express Mail would have the opposite effect, although none have been identified, to our knowledge. Express Mail may have some cost disadvantages that are real. Real cost disadvantages are equivalent to excessive costs (discussed in the previous section of these comments) in their effect on resource waste and harm to consumers.

financing, attributable to the Federal government's guarantee to repay loans made to the USPS; and 4) subsidization of unfunded liability for medical and retirement benefits to be paid to workers after retirement.⁴⁰

To avoid treating the USPS's government-based cost savings as real cost savings, we suggest that the calculation of attributable costs of Express Mail service, at least for use in setting minimum rates, be adjusted upward to reflect the value of these advantages of government status. Only after adjustment for these government benefits could attributable costs constitute an economically appropriate guide in setting the rate floor for Express Mail rates.⁴¹

If Express Mail were offered at the unadjusted attributable cost level, an equally efficient private firm would not be able to compete with Express Mail -- the firm could price as low as attributable cost, but the USPS could still undercut this price because of the subsidies and tax exemptions that the USPS receives. In fact, competitors would be limited in their ability to prevent the costs of Express Mail service from rising unnecessarily, because the subsidies and tax exemptions would insulate Express Mail from competition.⁴² Taxpayers would pay higher than necessary taxes to finance

⁴⁰ Reducing the Deficit: Spending and Revenue Options, Washington, D.C.: Congressional Budget Office, 1988, pp. 270-271.

⁴¹ A similar concern about the proper treatment of government subsidies to the USPS in competitive rate-making has been expressed by the Congressional Budget Office. Reducing the Deficit: Spending and Revenue Options, Washington, D.C.: Congressional Budget Office, 1988, pp. 270-271.

⁴² At the extreme, excess costs of Express Mail would have to exceed the level of the government-based cost advantages before equally efficient competitors could beat Express Mail prices.

government-based cost advantages, and consumers would pay higher than necessary prices for expedited mail as a result.

We suggest that Express Mail's attributable costs, for the purpose of establishing minimum rates for Express Mail, be increased to reflect the subsidies received from the government. This would alleviate part of the anticompetitive potential of allowing the USPS to lower its rates for Express Mail to those charged by its rivals.

**V. AN ALTERNATIVE TO ACCELERATED RATE REVIEW:
ESTABLISHING A "ZONE OF DISCRETION" IN PRICING EXPRESS MAIL**

Apart from the potential costs of increasing rate flexibility for Express Mail identified above, there appears to be little economic justification for imposing additional delays or administrative costs on the USPS's pricing decisions for Express Mail. Consequently, we suggest consideration of a "zone of discretion" in pricing Express Mail if the potential costs can be eliminated or substantially reduced.⁴³ Unlike the USPS's proposal, which continues to require hearings and delays for each rate change, a zone of

⁴³ Implementation of a zone of discretion in the rate making process may require the PRC to seek additional legislative authority. We note, however, that both the USPS and the PRC's Office of the Consumer Advocate have commented on the negative implications for competition and efficiency of procedural requirements that hinder adopting a zone of discretion approach and the advantages of taking a zone of discretion approach in regulating Express Mail rates. See, "Response to Memorandum of the United States Postal Service, Docket No. RM88-2," filed August 15, 1988, pp. 2 and 3; "Testimony of A. E. Kahn," p. 27; and "Petition of the United States Postal Service for a Rulemaking to Establish a New Procedure for Adjusting Rates for Express Mail Service between Omnibus Rate Cases," filed April 29, 1988, pp. 4-8.

discretion would entail establishing maximum and minimum rates (possibly through the normal omnibus rate hearing process) and then permit the USPS to change Express Mail rates within the zone of discretion without further regulatory approval. This zone would be conceptually similar to the range of pricing granted to railroads by the amended Interstate Commerce Act and the Interstate Commerce Commission.⁴⁴ The upper limit, in this instance, would be the price established through the previous omnibus rate hearings, and the lower limit would be attributable cost, adjusted for the subsidies received by the postal service. This approach would leave the USPS free to charge any price for Express Mail within the zone of discretion.⁴⁵ No further rate review or delay in changing rates would be required.

VI. CONCLUSION

Granting the USPS additional flexibility in pricing Express Mail could provide benefits through greater efficiency. Such a change, however, could also harm consumers if regulatory advantages the USPS enjoys are not simultaneously removed or reduced. Without removal or reduction of these advantages, the USPS's proposal might pose an unacceptably high risk of increased costs from inefficient and anticompetitive pricing. Therefore, we suggest that the USPS be granted additional pricing flexibility after two alterations are made to the current regulatory system. First, private firms should be allowed to lower their rates below the levels now specified in the

⁴⁴ See L. Phillips, "The Railroad Industry: The Road to Recovery," Business Economist 21:2 (April 1986), pp. 52-56.

⁴⁵ Provided that the rates were consistent with other laws governing the USPS's pricing activities.

urgent mail exemption to match or beat those of Express Mail. This would encourage Express Mail to minimize costs, and would avoid excessive quality competition among private suppliers. Second, Express Mail's attributable cost calculations (at least for purposes of determining the minimum permissible rates) should be adjusted upward to reflect the value of subsidies enjoyed by Express Mail because of its government affiliation. This change would insure that the USPS's pricing better reflects the true resource costs of providing Express Mail service.

By making the recommended changes, the potential costs of permitting greater rate flexibility for Express Mail could be eliminated. Once this is accomplished, we believe that the potential benefits of increased rate flexibility could best be realized by establishing a zone of discretion in setting Express Mail rates. After the primary restrictions and threats to competition have been removed, the market should be allowed to operate as freely as possible to benefit consumers.