



**STATEMENT OF
JAMES C. MILLER III
CHAIRMAN
BOARD OF GOVERNORS
U.S. POSTAL SERVICE
BEFORE THE
SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE,
AND THE DISTRICT OF COLUMBIA
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
U.S. HOUSE OF REPRESENTATIVES**

October 30, 2007

Chairman Davis, Ranking Member Marchant, and Members of the Committee: thank you for inviting my colleagues and me today. We welcome this opportunity to discuss Postal ratemaking principles and processes. As you well know, we are entering a new era under the Postal Accountability and Enhancement Act of 2006 ("new law"), and it is appropriate that we pause to consider where we have been and where we are going. Our hope is to share our thinking not only with you but with others in the Postal community. And we welcome an opportunity to obtain your guidance and to consider any and all inputs from those most immediately affected by our rate decisions -- those who actually pay for our services.

Ratemaking Principles

My fellow Governors and I recognize that Postal rate setting is inherently controversial. Inevitably, some customers will consider Postal charges too high. Some will protest that their rates are too high relative to those charged for other classes of mail. This is especially true because of the substantial common costs so characteristic of postal enterprises. As you probably know, the U.S. Postal Service has an elaborate cost attribution system, but with that is only able to attribute some 59 percent of its costs to various classes of mail. The rest -- 41 percent -- is "overhead." Thus, we start from the basic proposition that even if each and every class of mail just covered its attributable cost, the Postal Service would still be in the red some \$31 billion (\$75 billion annual cost X 0.41). Since the new law (as well as the old) requires the Postal Service to cover all costs and, with exceptions, that each class of mail cover its attributable costs, the ratemaking challenge is thus how much to "mark up" each class of mail.

In a competitive market, the non-attributable costs of a firm are "allocated" by relative demands. Those demands that are large and relatively inelastic (with respect to price) are allocated larger shares of overhead costs. This is a problem/solution that can be found in any modern economics textbook.

But the market for postal service is not perfectly competitive. In fact, only a minor portion -- only 10 percent -- of USPS's business is competitive, as recognized under the new law. On 90 percent of its business the USPS is market-dominant.

One approach to pricing problems such as this that is utilized in many public utility proceedings is "Ramsey pricing," an example of which is the application of the "inverse elasticity rule." Briefly, if the objective is to maximize economic efficiency, given costs and demands, the markup over attributable cost should be inversely related of the price elasticity of demand. In other words, those who have

little alternative but to use the service in question should pay a higher markup, and those who have alternatives should pay a lower markup.

While the principles are sound, the application of such an approach to USPS ratemaking is not so straightforward. First, the structure of demand by class of mail is constantly changing. Second, the price elasticity for one class of mail may depend on the price charged for another class (or subclass), as some mailers have the option of choosing among classes (or subclasses). Third, important modifications in service characteristics can affect demand elasticities. Fourth, as with any good business, the USPS should consider the effects of price changes on its consumer base – too rapid an increase can drive away customers who find themselves unable to adjust quickly to such higher distribution costs. Finally, a myriad of other factors, or principles, must be applied in making rate decisions. For the most part, it comes down to a simple matter: business judgment. And since we are all committed to making sure that, insofar as possible, the U.S. Postal Service operates as an efficient business enterprise, business judgment is especially important.

Despite these problems, within the discretion afforded by the new law, it is possible to glean from these and other applicable approaches some basic principles for postal ratemaking. Each class of service should cover, at a minimum, its attributable costs. Everything else equal, the markup over attributable cost should be inversely related to an informed judgment regarding the price elasticity of demand. Finally, rate changes should be tempered by business judgment.

Ratemaking Processes

Under the Postal Reorganization Act of 1970 (“old law”) the Board of Governors (BOG) proposed rate changes whenever, despite cost-cutting, it found a need for new revenue and asked the (old) Postal Rate Commission (PRC) for its review. After a protracted process, often lasting the statutory limit of 10 months, the PRC would offer its opinion and the rates it recommended. The BOG could accept the PRC’s rate recommendations, adopt them while appealing all or part of the PRC’s decision, or reject them outright -- at which point it could refile the initial rate package and after further consideration by the PRC could accept the PRC’s final decision or, if the rates recommended by the Commission would not generate the revenue requirement, then by unanimous vote the Governors could adopt the original package.

Under the new law, there is a distinction between competitive markets (packages and express services) and market-dominant markets (everything else). In competitive markets, the BOG may determine rate changes, and these will go into effect reasonably promptly. However, such changes are subject to challenge to the new Postal Regulatory Commission (PRC) on grounds that they would result in rates that are “too low.” As an aside, it is highly unlikely that the USPS would ever engage in “too-low pricing.” It is not our intention to engage in predatory pricing (that is, pricing below costs in order to drive out competition), since such an effort, in the long run, would be self-defeating. All of our rate proposals in the competitive area will be cost-justified.

With respect to market-dominant services, the BOG notices rate changes, but cannot implement increases for any class (as opposed to subclass) of mail which would result in a weighted-average increase exceeding the most recent increase in the consumer price index (CPI). While such a rate ceiling puts pressure on the USPS to control costs, it also means that, absent some truly significant reductions in real costs, it is unlikely that the BOG will propose rate decreases for individual classes as a whole. The reason is simple arithmetic: to propose a rate decrease, or even a rate increase less than the increase in the CPI, means that the overall increase will be *less* than the increase in the CPI.

The review process in the market-dominant area is also faster under the new law. After giving the PRC advance notice of rate changes, the Postal Service is allowed to put them into effect – unless the PRC determines that the increase actually exceeds the permitted (CPI) limit. Moreover, the

increases – both their levels and their structure – can be appealed to the PRC and perhaps overturned.

I hope this stylized characterization of the two processes is enough to convey our appreciation for the opportunities for ratemaking afforded by the new law, but also our concerns over how the new law will work in practice. Having said that, I want to express our appreciation to PRC Chairman Dan Blair and his fellow commissioners for their thoughtful, independent review of our proposals in the past and the Commission's just-released rules governing the review process under the new law. Indeed, I do not think it excessive to say the Governors view the Commission as having great expertise on Postal pricing, and that we look forward to and value the Commission's opinions.

Ratemaking Principles and Process in the Recent Rate Case

Mr. Chairman, I understand from your letter of invitation that a focus of this hearing is the recent rate case, R-2006-1. On May 3, 2006, after considerable discussion among ourselves, based in part on a thorough review of our financial situation and forecasts, from which we concluded we required additional revenue to meet our legal mandate, and after thorough debate over proposals made by Postal Service management – which, in turn, reflected extensive discussions with Postal customers -- the BOG approved a sweeping revision in Postal rates, announced its details, and send the package over to the PRC for review. This was the first such initiative since the omnibus rate filing of 2001.

The PRC held extensive hearings on our rate package and on February 26, 2007 issued its opinion and recommended decision. After several meetings about the PRC's response and vigorous debate among Board members, on March 19, 2007 the BOG accepted the PRC's recommended decision in major part, but appealed three items and concluded that because of (in)feasibility problems it would postpone for two months implementation of the rate increases for publications. On April 27, 2007 the PRC issued its recommendations about two of the three matters, and on May 1, 2007 we approved these recommended rates. Then, on May 25, 2007 the Commission saw merit in our request for some type of rate relief for flats, but since it did not offset the loss of revenue with increases in other classes or subclasses of mail, on June 19, 2007 we were forced to reject the new recommendation and left the original recommended rates in effect.

Then-existing rates (measured as revenue per piece), along with the rates the Governors submitted to the PRC and forecast cost coverage (expressed as a percent of attributable cost), are summarized in Table 1. The most significant characteristic of our initial package was to move from pricing by weight to pricing by shape as well as weight. For example, in First Class Mail we proposed distinct rates for letters, flats, and parcels, to recognize the cost differences among these shapes. In Priority Mail, we proposed pricing that takes the size of a parcel into consideration, along with its weight, since size often drives the transportation costs we incur. These "shape-based" rate approaches encourage efficiency and were included in the PRC's recommended decision.

Also, Table 1 summarizes the PRC's recommended rates, along with the forecast cost coverage. As you can see, the Commission's recommended decision tracks reasonably closely with our own package, at least at the level of detail depicted in the table. The differences were primarily at the rate design level and were the subject of the request for reconsideration mentioned earlier. The Commission also recommended a different rate structure for Periodicals, which led to its delayed implementation.

I would like to provide two additional tables for your consideration. Table 2 summarizes for major classes and subclasses of mail the forecast revenue share, the revenue per piece, the forecast attributable cost per piece, the contribution (that is, the markup over attributable cost), and cost coverage. As you will see from this table, the cost coverage ranges from 100 percent for Periodicals to 212 percent for First Class letters. The average cost coverage is 179 percent.

Table 3 is similar, but provides information on rates that would exist under Ramsey pricing. These figures are only approximate for the reasons cited above and because they are based on rather preliminary estimates of demand price elasticity by class and subclass. It is worth noting, however, that the structure of rates in Table 3 is reasonably close to the structure of actual rates in Table 2. In terms of (attributable) cost coverage they range from 100 percent for Express Mail to 233 percent for First Class letters. The major exceptions are that under Ramsey pricing the rates for Periodicals would be considerably higher, and the rates for Express Mail would be considerably lower.

There is one final matter I would like to address, and that is prompted by the results just discussed. From what I have heard about this hearing and from the lineup of witnesses, I gather a major issue is the effect of Postal rate increases on publications. There are two points I wish to make. First, under current rates, *the only* class of mail that pays *only* its attributable costs, making no contribution to overhead whatsoever, is publications. Before the recent rate case publications actually paid *less* than attributable cost, meaning they were *subsidized* by other classes of mail. As we interpret the new law, we *had no choice* but to raise rates on publications. Second, I am aware of the argument made by some that raising Postal rates infringes on publications' First Amendment rights. As the Committee is aware, however, the U.S. Constitution guarantees freedom of expression, not low-cost, and certainly not subsidized, access to a system of distribution.

Thank you, Mr. Chairman, Mr. Ranking Member, and Members of the Committee. That completes my statement. I shall be happy to address any questions you might have.

#

Table 1: Then-Existing Rates, BOG Rates, PRC Rates, and Cost Coverage

	Then-existing revenue per piece (\$)	BOG revenue per piece (\$)	PRC revenue per piece (\$)	BOG Cost Coverage (%)	PRC Cost Coverage (%)
First-Class Mail					
Letters (all shapes)	0.392	0.418	0.419	212	212
Cards	0.220	0.242	0.233	161	155
Total First-Class	0.381	0.407	0.407	210	209
Priority Mail	5.513	6.265	6.263	150	150
Express Mail	16.583	18.656	18.656	171	170
Periodicals					
Within County	0.095	0.118	0.112	98	100
Outside County	0.266	0.297	0.297	100	100
Total Periodicals	0.253	0.283	0.282	100	100
Standard Mail					
Enhanced Carrier Route	0.172	0.187	0.184	209	206
Regular	0.211	0.231	0.230	170	171
Total Standard Mail	0.198	0.218	0.216	179	179
Package Services					
Parcel Post	3.334	3.912	3.884	113	114
Bound Printed Matter	1.079	1.205	1.205	120	119
Media & Library Mail	2.153	2.538	2.538	104	104
Total Package Services	1.991	2.231	2.230	113	114
International Mail	2.240	2.438	2.438	125	125
Total All Mail	0.323	0.349	0.347	179	178
Special Services					
Registry	11.882	17.848	13.578	86	132
Certified	2.400	2.650	2.650	148	148
Insurance	2.625	2.480	2.478	105	130
COD	6.522	7.216	7.037	113	110
Money Orders	1.336	1.498	1.454	153	150
Stamped Cards	0.020	0.020	0.020	135	135
Stamped Envelopes	0.053	0.046	0.046	104	104
Post Office Box	53.010	58.368	58.367	156	157
Total Mail & Services				178	179

Table 2: Revenue Shares and Cost Coverage Under Current Postal Rates

	Revenue Share (%)	Revenue per piece (\$)	Attributable cost/piece (\$)	Contribution (rev - cost) per piece (\$)	Cost coverage (%)
First-Class Mail					
Letters (all shapes)	46.8	0.419	0.198	0.221	211.6
Cards	1.8	0.233	0.150	0.083	155.4
Total First-Class	48.6	0.407	0.195	0.212	208.9
Priority Mail	6.8	6.263	4.181	2.082	149.8
Express Mail	1.0	18.656	10.946	7.710	170.4
Periodicals					
Within County	0.1	0.112	0.112	0.000	100.1
Outside County	3.1	0.297	0.297	0.000	100.2
Total Periodicals	3.2	0.282	0.281	0.000	100.1
Standard Mail					
Enhanced Carrier Route	7.8	0.184	0.089	0.095	206.3
Regular	22.9	0.230	0.135	0.095	170.8
Total Standard Mail	30.7	0.216	0.121	0.095	178.5
Package Services					
Parcel Post	1.9	3.884	3.410	0.474	113.9
Bound Printed Matter	1.0	1.205	1.009	0.196	119.4
Media & Library Mail	0.6	2.538	2.448	0.090	103.7
Total Package Services	3.5	2.230	1.962	0.268	113.7
International Mail	2.5	2.438	1.951	0.487	124.9
Total All Mail	96.3	0.347	0.195	0.153	178.4
Special Services					
Registry	0.1	13.578	10.282	3.296	132.1
Certified	0.9	2.650	1.792	0.858	147.9
Insurance	0.1	2.478	1.913	0.565	129.5
COD	0.0	7.037	6.377	0.660	110.3
Money Orders	0.3	1.454	0.969	0.485	150.0
Stamped Cards	0.0	0.020	0.015	0.005	135.2
Stamped Envelopes	0.0	0.046	0.044	0.002	104.1
Post Office Box	1.3	58.367	37.262	21.104	156.6
Total Mail & Services	100.0	0.364	0.203	0.161	179.3

Table 3: Existing Rates vs. Ramsey (Inverse Elasticity) Rates

	Current revenue per piece (\$)	Price Elasticity of Demand	Ramsey revenue per piece (\$)	Current Cost Coverage (%)	Ramsey Cost Coverage (%)
First-Class Mail					
Letters (all shapes)	0.419	-0.155	0.462	212	233
Cards	0.233	-0.426	0.168	155	112
Priority Mail					
	6.263	-1.023	4.299	150	103
Express Mail					
	18.656	-1.645	10.958	170	100
Periodicals					
Within County	0.112	-0.141	0.165	100	148
Outside County	0.297	-0.276	0.356	100	120
Standard Mail					
Regular	0.230	-0.298	0.253	171	188
Enhanced Carrier Route	0.184	-1.020	0.093	206	104
Package Services					
Parcel Post	3.884	-1.086	3.558	114	104
Bound Printed Matter, Media, Library	1.474	-0.659	1.397	113	107
Special Services					
Registry	13.578	-0.170	14.032	132	136
Insurance	2.478	-0.243	2.346	130	123
Certified	2.650	-0.179	2.404	148	134
COD	7.040	-1.344	6.604	110	104
Money Orders	1.454	-0.600	1.023	150	106