

**COMMISSION AUTHORIZED**

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

Procedures for Consideration of  
Contract Rules, 1989-1990

Docket No. RM89-5

**COMMENTS OF  
THE STAFF OF THE BUREAU OF ECONOMICS OF THE  
FEDERAL TRADE COMMISSION<sup>1</sup>**

(submitted February 20, 1990)

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<sup>1</sup> 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.

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I. INTRODUCTION

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) appreciate the opportunity to submit these comments to the Postal Rate Commission (PRC) concerning the desirability of reorienting "mail classification to deemphasize the unitary character of at least some classes or subclasses, and treat them more as groupings of separable operational functions" (separable functions). Of the several questions posed by the PRC

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in this matter, we limit our comments to those concerning economic costs and benefits: questions 1 and 3.<sup>2</sup>

The mail classification system of United States Postal Service (USPS) usually bundles a variety of potentially separable postal functions. Functions within the bundle include collection of mail through a local network of pick-up points, sorting of mail, transportation of mail from one local area to another, and distribution of mail through a local network of delivery routes.<sup>3</sup> Unbundling refers to the policy of providing one or more postal functions, separate from the traditional bundle of services, at a separate price.

Our analysis indicates that the economic desirability of offering unbundled postal services (in addition to bundled services) depends on (1) the prospective cost savings from unbundling, (2) the effects of unbundling on the true costs of services that remain offered exclusively by the USPS,<sup>4</sup> and (3)

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<sup>2</sup> There are other concerns (e.g., the intent of the Postal Reorganization Act, etc.) that the PRC may wish to consider in its decisionmaking in this matter. We limit our comments to the likely effects of various unbundling possibilities on economic efficiency and consumer welfare.

<sup>3</sup> This list is an illustration of how postal functions might be separated. This is not intended to be a definitive list of separable postal functions. We assume in the comment that most, if not all, mail must at least go through the collection, sorting, and delivery functions, whether or not the USPS performs all these functions.

<sup>4</sup> By "true cost" we mean the opportunity costs of the resources used. When we discuss cost-shifting by a regulated monopolist we are discussing accounting costs that are allocated to a function. These costs may not reflect opportunity costs and may be fictitious.

the effects of unbundling on the incentives and ability of the USPS to shift costs from the competitive functions to the remaining regulated functions or segments.

If unbundling a function is likely to provide cost savings to consumers and it is unlikely to increase the costs of the remaining services of the USPS, then unbundling is likely to be economically desirable due to increased competition among postal service providers.

If unbundling is unlikely to provide current cost savings, but it is also unlikely to increase the true costs of other services of the USPS, unbundling may still be desirable because it may encourage the USPS to adopt future cost-saving techniques. At the same time, society will bear little cost from unbundling under these circumstance (since consumers have no incentive to patronize higher cost suppliers).

If unbundling is likely to increase the true costs of other USPS services, whether or not it is likely to decrease costs of the particular function that is unbundled, then unbundling may still be desirable. In this case, imposing a fee on private suppliers of this function, to offset the increased true costs of the USPS, may be an attractive option. Such a fee could preserve incentives to minimize costs as well as avoid unwarranted increases in the costs of the USPS. The fee should be equal to the increase in the costs of services provided exclusively by the USPS.

Regardless of whether unbundling lowers or raises the true costs of other functions, however, the PRC will need to consider whether allowing competition in some functions might allow the regulated firm, USPS, to inefficiently "shift costs" from competitive functions to their regulated monopoly functions (if any remain). Such cost-shifting could, if left unchecked, thwart any potential entry and result in higher overall postal service pricing.

## II. FEDERAL TRADE COMMISSION STAFF EXPERTISE

The FTC is an independent regulatory agency responsible for maintaining competition and safeguarding the interests of consumers.<sup>5</sup> The staff of the FTC, upon request by federal, state, and local government bodies, often analyze regulatory or legislative proposals that may affect competition or the efficiency of the economy. In the course of this work, as well as in antitrust and consumer protection research and litigation, the staff apply established and recent developments in economic theory and empirical analyses to competition and consumer protection policy issues, including efficiency rationales for rate regulation and entry restrictions.

The FTC Bureau of Economics staff have commented previously on various issues before the PRC. Of particular relevance to this inquiry are our comments on the Complaint from the Third

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<sup>5</sup> 15 U.S.C. Section 41 et seq.

Class Mail Association (PRC Docket No. C89-1) and our comments in the Monopoly Theory Inquiry (PRC Docket No. RM89-4).<sup>6</sup>

### III. COSTS AND BENEFITS OF UNBUNDLING POSTAL SERVICES

(Question 1)

#### A. Introduction

In considering the advisability of unbundling separable postal functions, the PRC may wish to compare the total costs of providing postal services to consumers under the current system and under an alternative system in which mail classes and rates are unbundled.<sup>7</sup>

Under current mail service classifications and the private express statutes,<sup>8</sup> consumers of some classes of mail generally

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<sup>6</sup> These comments were filed on February 28, 1989 and September 1, 1989, respectively.

<sup>7</sup> The term "consumers" is used here to denote ultimate consumers of postal services as well as intermediate buyers of postal services whose product-prices charged to ultimate consumers reflect mailing costs.

<sup>8</sup> Our comments do not address the potential conflict between the private express statutes and full unbundling of postal functions. Full unbundling, i.e. consumers can buy all, some, or none of their postal services from suppliers other than the USPS, should be efficient if no postal functions exhibit the characteristics discussed in Section III.C. If some functions have these characteristics, unbundling the rest of the postal functions should still maximize benefits and minimize costs so long as significant cost-shifting from competitive functions to the remaining regulated monopoly functions does not occur. For the services with the characteristics discussed in Section

must purchase an entire bundle of services from the USPS or do without these postal services entirely.<sup>9</sup> In contrast, a buyer of postal services in an unbundled system would be likely to face a wider array of choices similar to that faced by consumers of other goods and services. For many products and services, the consumer has at least three choices in addition to buying a complete bundle of services from a single supplier. These choices include: producing all the services oneself, producing some services and buying some, and buying all the services from a variety of suppliers.

In some cases the cost of buying a bundle of services from a single producer is much less than buying the same services separately. In such cases, most consumers will naturally elect to buy the bundle of services, but no restriction on unbundling the service is necessary to obtain this cost minimizing result. For example, most consumers elect to buy their automobiles

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III.C., a system of fees (discussed in Section III.D.), rather than entry restrictions, may provide the most efficient results.

Unbundling is likely to result in one or more suppliers offering a wide variety of combinations of postal functions ranging from single functions to combinations similar to those currently offered by the USPS. Actual cost functions and competitive incentives then would determine which combinations are sufficiently popular to be offered.

<sup>9</sup> Some limited unbundling options have been made available in the form of discounts granted when a mailer performs a particular task, thereby relieving the postal service of the costs associated with this task. Sorting discounts and nine-digit zip code discounts are examples. Distance related rate differences are also a form of unbundling because consumers have the option of obtaining a lower rate by transporting their items (in bulk) closer to the final destination before entering them into the USPS mail stream.

already assembled because the costs of gathering parts and separately contracting for assembly are relatively high. No restriction on such contracting is necessary to make bundling of automobile assembly functions almost the universal choice of consumers.

In other instances, some consumers may be able to produce one or more services in a bundle at lower cost. In such instances, required bundling of these services may result in higher costs and less satisfaction for consumers. For example, many consumers continue to prefer to prepare and cook their own food rather than to buy prepared meals. Unbundling in this instance allows some consumers to assemble and cook their own food while other consumers can purchase prepared items or dine in restaurants. Regulations which require consumers to purchase all food items in prepared form would increase costs to society and force many consumers to pay prices above their own costs and to obtain services they do not want.

When consumers in a market economy face a "make or buy" decision about an activity (separable function), they have a profit incentive to buy that service from the lowest cost supplier(s), and society also benefits from this. In some narrowly defined cases (discussed below), however, the cost savings from unbundling particular services may result in higher costs of other services provided by the USPS that off-set the former gains.



We now turn to the questions of incentives to be the lowest cost suppliers (Section B) and off-setting cost increases (Sections C and E).

B. Differences in Incentives to Minimize Costs

From an economic perspective, consumers are generally better off under a competitive market mechanism, unless there are substantial market failures that can only be mitigated by restricting buyer choices to a monopoly supplier. Competition provides incentives to improve economic performance, that is, to minimize costs, to improve quality, and to develop new products and methods of production.<sup>10</sup> Without competition, the incentives to minimize costs may be attenuated. Unbundling would increase consumers' choices of suppliers and therefore increase competition in postal services.

Under a mail classification system with unbundling, if the USPS offers the lowest rate on any particular function or set of separable functions and its service is of equivalent quality, consumers can be expected to patronize the USPS for those functions. And, if the USPS is the lowest cost producer of all

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<sup>10</sup> This is the fundamental economic rationale for competitive markets. See, for example, Scherer, F., Industrial Market Structure and Economic Performance, 2nd edition, Chicago: Rand McNally, 1980.

Incentives to innovate do not guarantee that specific innovations will be successful or that the timing of innovation will be optimal. Innovation typically involves a significant risk of failure.

separable and unbundled functions and sets prices close to its minimum costs, the USPS will remain the monopoly supplier. If the USPS is not the lowest cost producer, however, an unbundling of supply could give consumers an increased opportunity to reduce their postal costs by patronizing lower cost suppliers or by supplying the functions themselves.

In our Monopoly Theory Comment (Docket RM89-4), we discussed theoretical reasons for concern that production under a protected monopoly need not minimize costs. Recent extensions of economic theory in the area of "agency" relationships, including the theories of bureaucracy, x-inefficiency, and public choice, indicate that government monopolies (unconstrained by competition) are likely to be inefficient. Competition through the unbundling of services could help offset this inefficiency by providing incentives for the USPS to minimize costs.

In the theory of bureaucracy, competitive pressure from customers who provide their own services and from other providers can establish limits on the costs of the government sector by providing elected officials with increased information on minimum costs and on alternative levels of service. With better informed officials, managers' efforts to inflate an enterprise's budget will increase the probability that the government enterprise will be displaced by outside producers (private or public) or otherwise more strictly constrained. In the x-inefficiency theory, the possibility of outside production makes excessive costs more obvious and likely to draw attention. This may

constrain cost increases and may improve group norms of work effort. In public choice theory, alternative suppliers of an initially monopolized service reduce the relative organizing advantages of the managers of the monopoly by forming well-organized and well-informed countervailing interest groups that often oppose the interests of budget-maximizing government enterprises or challenge coalitions between politicians and enterprise managers that exclude competition.<sup>11</sup>

C. The Problem of Increased Costs of Other Postal Services

Allowing consumers to select the lowest cost suppliers for a particular separable postal function may not be optimal if doing so increases the true costs of other services provided by the USPS monopoly. In particular, the entry of an additional supplier may not be efficient if postal services are characterized by subadditivity.<sup>12</sup> Even if costs are subadditive, a natural monopoly, the least cost industry structure, may not be able to sustain itself against new entry.<sup>13</sup> If a natural

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<sup>11</sup> Also see Shapiro, C., and R. Willig, "Privatization to Limit Public-Sector Discretion," unpublished, 1989.

<sup>12</sup> See our comments in the Monopoly Theory Inquiry (Docket No. RM89-4).

Costs are subadditive when the cost of producing some set of products or functions is lower when it is produced by a single firm than when the same set is produced by more than one firm.

<sup>13</sup> Sustainability means that the market demand and cost functions allow the monopolist to price such that (1) the market clears (i.e. the monopolist produces all that is demanded at that price), (2) the monopolist at least breaks even, and (3) entry is

monopoly cannot sustain itself, some restrictions on entry may be economically efficient.

When a firm produces several products, as does the USPS, it may be especially difficult to determine whether the firm is a natural monopoly, and if so, whether the natural monopoly is sustainable. This difficulty arises because multiproduct production may make costs dependent upon the mix (scope),<sup>14</sup> as well as the quantities (scale),<sup>15</sup> of the different products produced.

A full discussion of the conditions under which a multiproduct natural monopoly exists, and when it is sustainable, is available in the literature.<sup>16</sup> The chief implication of this literature can be succinctly summarized: there is no efficiency basis for protecting a monopolist from entry unless there is a good reason to believe that the industry is an unsustainable natural monopoly. Unless the monopoly is unsustainable, market forces will induce and sustain the natural monopoly as the least-

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unprofitable.

When costs are such that total costs in an industry are minimized when there is a single producer, the industry is termed a natural monopoly.

<sup>14</sup> Cost relationships in which costs of production for a product are lower when the product is produced in conjunction with one or more other products are termed economies of scope.

<sup>15</sup> Cost relationships in which the average costs of production are lower when more of the product is produced are termed economies of scale.

<sup>16</sup> See Baumol, Panzar, and Willig, op. cit.; Bailey, E. and A. Friedlaender, "Market Structure and Multiproduct Industries," Journal of Economic Literature, 20 (1982), pp. 1024-48; and Sharkey, op. cit.

cost industry structure. Indeed, allowing free entry into the provision of a bundle of postal services that is a sustainable natural monopoly will have no impact because no firm could profitably enter the market, assuming the monopolist minimized costs.<sup>17</sup>

Similarly, if conditions for sustainable natural monopoly prevail, permitting unbundling will have no effect if the monopolist is already cost minimizing and pricing accordingly. If the monopolist is not already cost minimizing, however, increasing competition through unbundling will increase its incentives to do so.

Although the discussion above raises the theoretical possibility that bundling postal services under a protected monopoly represents an optimal industry structure, there is little empirical evidence that separable postal functions are characterized by subadditivity and unsustainable natural monopoly characteristics.<sup>18</sup> Neither scholars nor the USPS have provided

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<sup>17</sup> Although no static efficiency gains might be expected in this case, gains from increased incentives and opportunities to innovate in the future might accompany unbundling.

<sup>18</sup> For a discussion of empirical tests for subadditivity and unsustainable natural monopoly see Evans, D., and J. Heckman, "Multiproduct Cost Function Estimates and Natural Monopoly Tests for the Bell System," in Evans, D., Ed., Breaking Up Bell: Essays in Industrial Organization and Regulation, New York: North Holland, 1983; Evans and Heckman, "A Test for Subadditivity of the Cost Function with an Application to the Bell System," American Economic Review 74:4 (September 1984), pp. 615-623; and our testimony in Monopoly Theory Inquiry: Docket No. RM89-4, pp. 372-377. If cost, output, and input price data are available for the various services provided by the postal service, it should be possible to assess whether the necessary conditions for subadditivity are met. If these conditions are not satisfied,

evidence of these conditions. We suggest that, barring evidence of such problems, a policy of unbundling is likely to be economically efficient.<sup>19</sup> If the PRC were to proceed with a restructuring of the mail classification process to unbundle postal services, a reasonable priority list of particular services to be unbundled might be derived by identifying functions that are already widely produced by consumers or are contracted out by the postal service to private suppliers.

D. An Alternative When Free Entry May Increase Costs

If unrestricted entry into a separable postal function will (or might) increase the USPS's true costs in other services where the USPS is the sole supplier, one option is simply to forbid entry in that particular separable function. This option,

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the sustainability issue need never be addressed, and a strong case can be made for allowing free entry into the provision of all postal services. If they do exist, then entry prohibitions may be appropriate if unsustainability can also be shown to exist and no economically appropriate fee system on other suppliers can be applied to take into account these scale and scope effects of entry.

Anecdotal evidence suggests that the question of subadditivity and unsustainable natural monopoly are most likely to be relevant in the local pick-up and delivery functions. See our comments and testimony in Monopoly Theory Inquiry, Docket No. RM89-4, pp. 380-390.

<sup>19</sup> The process of evaluating unbundling proposals should help to identify the core of postal services, if any, where subadditivity or unsustainable natural monopoly conditions are most likely to exist. This may help to clarify where an efficiency rationale for restrictions on entry, such as the private express statutes, are most persuasive. Consequently, the information gathered from evaluating unbundling proposals could be useful for the PRC's Monopoly Theory Inquiry (Docket RM89-4).

however, may lead to higher production costs because the benefits of competition are completely lost. (See Section III. B.) An option that preserves competitive incentives for the USPS to minimize costs, but which also avoids an inefficient loss of economies of scale and scope at the USPS,<sup>20</sup> is to charge a fee to entrants that compensates the USPS for loss of scale or scope economies.<sup>21</sup> Such a fee could be set to compensate the USPS for any true increase in the cost of other USPS mail operations.<sup>22</sup> The fee system would allow for entry by low cost producers and would, therefore, allow consumers to pay lower rates for postal services.<sup>23</sup> That is, consumers would continue to buy bundled

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<sup>20</sup> If unbundling results in loss of economies of scale or scope to the USPS, society will bear these higher costs regardless of whether the USPS is compensated. If alternative providers are able to profitably operate as well as compensate the USPS, the cost savings of the private providers, however, must exceed the cost increases in the operations of the USPS. On net, total costs would have to decline.

<sup>21</sup> See our comments on the Complaint of the Third Class Mail Association, Docket No. C89-1.

<sup>22</sup> We assume here that the fee is calculated to compensate the USPS for increased costs and that the USPS minimizes the increases by appropriately reallocating inputs just as a profit maximizing, efficient nonsustainable monopoly would do. Limiting the fee to this level will give the USPS incentives to make the required reallocations of inputs.

<sup>23</sup> See our comments on the Complaint of the Third Class Mail Association, Docket No. C89-1. In that comment, we suggested that the USPS expand its current array of rate discounts to allow a rate discount for a particular potentially separable function - user-delivery of addressed third class mail. The final price of the stamp (that must be affixed to all mail using postal roads or boxes) would reflect the loss of economies of scale and scope at the USPS, if any.

A similar approach has been suggested by a consultant for the Direct Marketing Association (DMA). The DMA proposed to the USPS that direct mail firms be allowed to "rent" the use of mail

services from the USPS if the bundle of services is cheaper than if the services were unbundled and purchased separately.<sup>24</sup>

The preceding discussion of economic efficiency criteria and efficiency enhancing policies is summarized in Figure 1. In Figure 1, unbundling is the preferred policy if there are no subadditivity problems or if subadditivity occurs in the context of a sustainable natural monopoly. Unbundling with appropriately calculated fees on non-USPS suppliers is the preferred policy if subadditivity occurs in the context of an unsustainable natural monopoly. In either case, however, the PRC must ensure that the USPS cannot "shift" costs to any remaining regulated monopoly functions.

#### E. Cost-shifting and Misallocation of Costs under Unbundling

While unbundling has significant potential to improve consumer welfare, it will do so unambiguously only if the PRC can

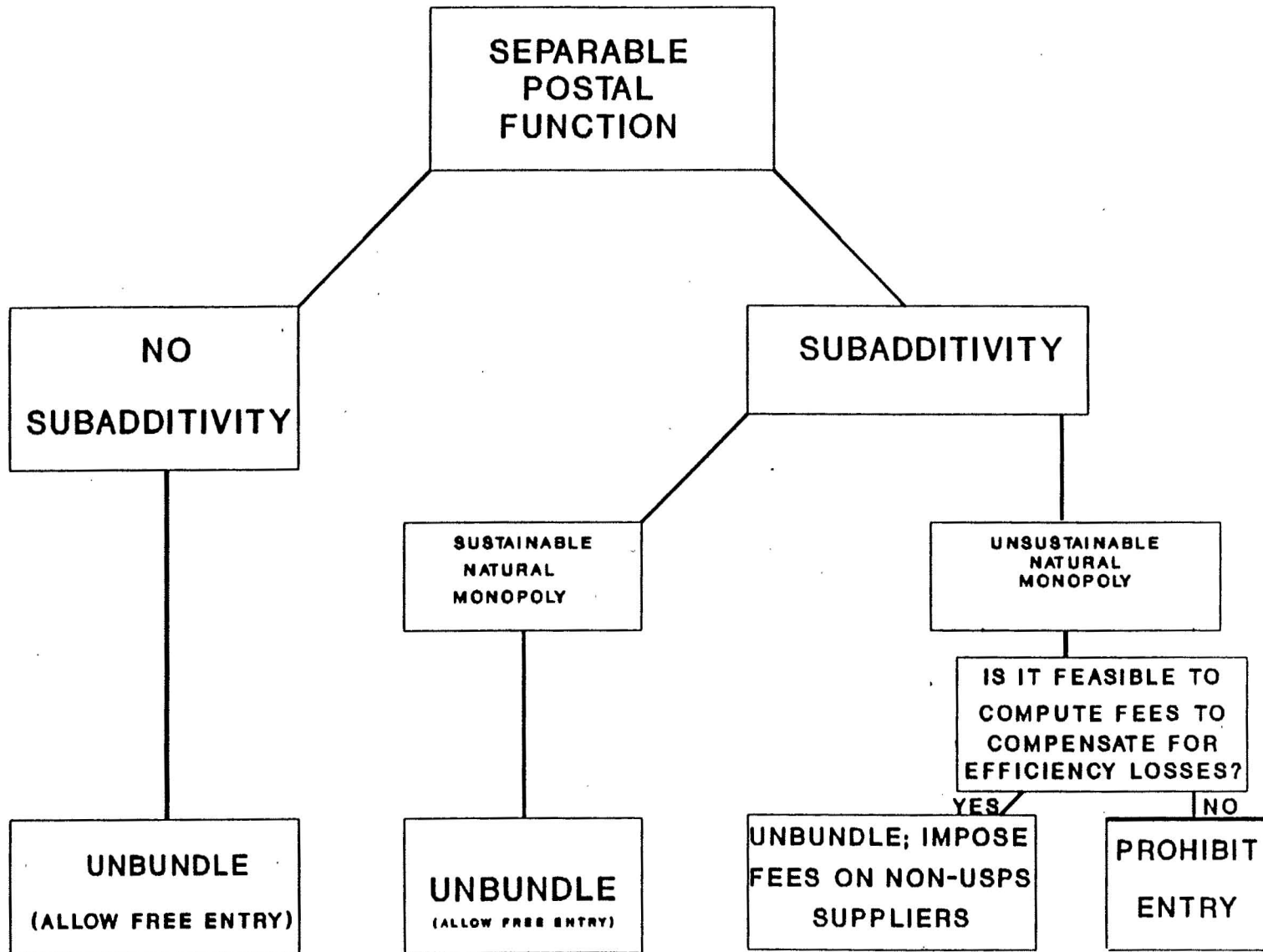
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boxes from the USPS by purchasing and affixing a stamp to each piece that would reflect the USPS's loss of overhead (not necessarily lost scale and scope economies), estimated to be 3/4 cents per item. (The private express statutes currently give the USPS exclusive rights to use these receptacles at each address.) All the collecting, sorting, transportation, and delivery functions would be provided by private firms. (Letter to Frank Heselton, Assistant Postmaster General, Rates and Classification, from Robert W. Inhofe, dated April 14, 1988.)

<sup>24</sup> The public interest will be served best if care is taken to determine accurately the appropriate magnitude of the "delivery discount." Like other cost savings calculations considered by the PRC, this may prove to be a difficult determination to make and one that requires considerable time to refine.



**FIGURE 1**



constrain efforts by the regulated firm (the USPS) to "shift" the accounting costs of serving the unregulated segment(s) to the remaining regulated segment. The unbundling strategy discussed here may give the USPS the incentive to shift costs away from those service segments where they face new competition into those segments where they retain a regulated monopoly. Such actions could allow the USPS to misallocate costs and to deter new entry through artificially lower costs or lower prices in the competitive segment. The losses generated by such activity could be recouped through higher prices (justified by the higher shifted costs) in the regulated monopoly service segment. If such cost shifting was extensive enough, the prices of postal services might rise under an unbundling scheme.<sup>25</sup>

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<sup>25</sup> For a discussion of the incentives of a regulated monopolist to shift costs to the regulated segments, see Brennan, T., "Cross-Subsidization and Discrimination by Regulated Monopolists," Economic Analysis Group Discussion Paper 87-2, Department of Justice, March 19, 1987 and Braeutigam, R. and Panzar, J., "Diversification Incentives Under 'Price-Based' and 'Cost-Based' Regulation," RAND Journal of Economics 20:3, (Autumn 1989), pp. 372-91. Braeutigam and Panzar also discuss additional welfare reducing incentives of profit-maximizing regulated monopolists who serve multiple markets (e.g., inefficient technology choice and capital investment, overproduction in competitive markets, and failure to minimize costs). They argue that many of the incentive problems might be overcome through price cap regulation rather than the more traditional rate of return regulation.

#### IV. APPROACHES TO THE UNBUNDLING PROCESS

(Question 3)

If the PRC elects to pursue a policy of increased unbundling, it may wish to consider three alternative approaches.<sup>26</sup> In accord with the previous discussion, we assume that the objective of an unbundling policy is to increase consumers' options while increasing incentives to minimize true costs.

The first approach, the primary alternative identified in the request for comments, is to establish new mail classifications for separable postal functions. Under this system, consumers would have the option of buying one or more services from the USPS or from other suppliers based on the relative attractiveness (price and quality) of their services. Both the USPS and private firms would be free to offer directly competing services and bundles of services. This system maximizes consumer choices and provides the potential for significant gains to consumers. This new system could, however, increase search and transactions costs for some consumers as they consider buying postal services from several sources for the

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<sup>26</sup> A fourth approach, allowing contracting between the USPS and specific customers, is not considered here, as requested in the PRC's notice.

first time. These costs may initially inhibit full consumer utilization of the new range of postal alternatives.<sup>27</sup>

A second alternative for increased unbundling, one in limited use already, is worksharing. In this system, consumers buy at least some services from the USPS and may garner various discounts by performing functions for the USPS. While expansion of this system would provide net benefits to consumers, it puts more limits on consumer choice than full unbundling because it limits competition to a subset of separable postal functions. In addition, like pure unbundling, worksharing may involve additional search and transactions costs for consumers who must separately locate and purchase additional postal services from other sources before transferring the items to the USPS.<sup>28</sup>

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<sup>27</sup> This problem may be less severe after the transition period as more consumers become used to mixing postal providers and as brokers arise to offer combinations of services from various suppliers.

Individual consumers and firms with modest or irregular postal demand are likely to have larger per item search and transaction costs. This may prompt these consumers to forego using the services of alternative postal providers until the experience of other users effectively reduces search costs.

The entry of brokers offering competing bundles of services, may itself require additional consumer search costs. However, these brokers have strong incentives to provide advertising and other forms of truthful information that should help quickly inform consumers of the attributes of their postal service combinations.

<sup>28</sup> Here too, the problem of search and transactions costs may be less severe after the transition period as consumers become used to mixing postal providers and as brokers arise to offer particular combinations of services from various suppliers. As in the case of pure unbundling, individual consumers and firms with modest or irregular postal demand are likely to have large per item search and transaction costs.

A third alternative is to permit the USPS and interested private firms to transform themselves from vertically integrated single-source suppliers of postal services into postal service retailers offering services of several different suppliers.<sup>29</sup> (This option would be most effective as an addition to increased unbundling through classification changes and workshare programs.) The USPS could offer consumers a wide variety of services, some of which it produces internally and some of which others produce.<sup>30</sup> Competing postal retailers could do the same. For example, the USPS could offer 3rd class mail service with sorting conducted by the USPS or with sorting provided by a particular private firm.<sup>31</sup> The retail outlets of parcel post firms, convenience store chains, and oil companies, for example, would be free to do the same.

In comparison to classification changes alone or expanded workshare programs alone, a one-stop shopping approach would

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<sup>29</sup> Some private parties have already established retail mail service firms that offer services from several alternative providers when a service (such as expedited mail and parcel post) has been opened to competition. These firms may also offer options for additional premium services (such as enhanced post office box security) that exceed the quality of service customarily provided by the USPS.

Under this scenario, the USPS and other postal retailers would offer the services of other firms at a mark-up. Competition between postal retailers, including the USPS, would help to restrict retail mark-ups.

<sup>30</sup> With its wide network of sales offices and widespread familiarity to consumers, the USPS might well have a significant first mover advantage in this role.

<sup>31</sup> Similarly, a brokerage firm could offer document mailing with air transport by a private air express company and home delivery by the USPS.

increase consumers' search costs the least. Under this approach, even consumers with relatively high search and transactions costs would be readily able to compare the prices and features offered by different suppliers of different separable functions at familiar USPS locations. These consumers would also be able to readily arrange to obtain combinations of services that best meet their price and quality preferences. Under this alternative, enhanced competition should exist between the USPS and other postal retailers and should provide incentives to minimize costs, price competitively, and improve the quality of service.

If the PRC chooses to pursue these unbundling options, and some products or services continue to be produced exclusively by the USPS, some regulatory precautions to prevent cross subsidization from the monopolized function to other functions may be efficient and promote competition.

## V. CONCLUSIONS

Reorientation of the mail classification system toward unbundling separable postal functions is an attractive economic proposition if doing so will not (1) raise the true costs of other services produced by the USPS, nor (2) result in significant cost-shifting from the unregulated competitive sectors toward any remaining regulated monopoly sectors. Unbundling has the potential to increase competitive incentives to minimize true costs in the unbundled functions and to provide

net benefits to consumers. Where unbundling could increase the costs of other services of the USPS, an attractive policy option may be to allow unbundling, but to charge entrants a fee that compensates the USPS for losses of economies of scale and scope. These unbundling options would be most viable if the PRC can effectively monitor any cost-shifting behavior by the USPS to ensure that the costs from the newly competitive sectors are not inappropriately allocated to any remaining regulated monopoly sectors. Unbundling which includes giving the USPS an option to serve as a retailer of postal services produced by independent firms as well as internally may be particularly attractive because it could reduce search and transactions costs for consumers.