Enhancing Competition By Unbundling the Postal Administration

By

John Haldi

and

William J. Olson

Thirteenth Conference on Postal & Delivery Economics
Antwerp, Belgium
June 1 – 4, 2005

Contents

Page

INTRODUCTION 1

1. RATIONALE FOR UNBUNDLING AN INTEGRATED POSTAL NETWORK 2

2. WHAT CONSTITUTES UNBUNDLING OF AN INTEGRATED POSTAL NETWORK 4

3. UNBUNDLING THE USPS 6

3.1 The U. S. Mail Service 7

3.1.1 USMS Ownership 8
3.1.2 USMS Facilities 10
3.1.3 USMS Transportation 11
3.1.4 USMS Employees 12
3.1.5 USMS Operations 13
3.1.6 Pricing of USMS Services 13

3.2 The U. S. Delivery Service 18

3.2.1 The Universal Service Obligation and Single-Piece Mail 20
3.2.1 USDS Ownership 21
3.2.2 USDS Facilities 22
3.2.4 USDS Transportation 23
3.2.5 USDS Employees 23
3.2.6 USDS Ancillary services 24
3.2.7 USDS Attributable and Residual Costs 24
3.2.8 USDS Rates, Acceptance and Payment 25

4. ADVANTAGES OF UNBUNDLING AN INTEGRATED POSTAL NETWORK 27

References 30

Enhancing Competition By Unbundling the Postal Administration

By

John Haldi & William J. Olson
Haldi Associates, Inc. and Olson Law Offices

INTRODUCTION

Attempts to bring the rigors of competition to postal authorities via de-regulation have stumbled repeatedly over the following dilemma: (i) the Universal Service Obligation ("USO") has powerful political support; (ii) the postal monopoly is asserted to be necessary to assure funding of the USO; and (iii) a fully de-regulated government monopoly is unacceptable. The unbundling model presented in this paper offers a solution to this dilemma. Although scope of the existing monopoly over delivery would not be reduced by this proposal, unbundling the upstream portion of the network would reduce substantially the amount of resources protected by the monopoly, while preserving the USO.

The concept of unbundling the United States Postal Service ("USPS") was posited over a decade ago in an unpublished paper by Rogerson and Treworgy (1994). That paper suggested bifurcating the USPS into two separate entities, one consisting of monopoly services, and the other of competitive services. Such structural separation also was discussed briefly during debate over legislative reform of the USPS.[1] Aside from mention in these works, which received limited attention, the developing postal literature is devoid of discussion

---

[1] Postal Service (2002), App. B, p. B-3.

about unbundling the USPS, or any other postal administration, into separate entities. This void in the literature could stem from the fact that postal administrations have been structured as unitary, vertically integrated networks for so long that it is difficult to imagine them being organized in any other way.

Countries that have reduced or abolished the monopoly as part of postal reform have seen only limited entry by competitive delivery firms, largely because the need to replicate the delivery function on a wide scale presents a formidable barrier to entry. Unbundling the postal administration offers a more feasible and expeditious way to open a significant portion of a country's postal network to effective competition. Using the USPS as a prototype, this paper describes how unbundling of a postal administration could function. Particular attention is paid to the thorny issue of the USO. Separating the delivery function and opening contestable activities to true competition presents a feasible and meritorious option that deserves serious consideration by policy makers.

The paper is organized as follows: (1) The basic rationale for unbundling is stated. (2) Requirements for unbundling an integrated network are defined. (3) A restructured USPS network is described. (4) The merits of such a restructuring are assessed.

1. RATIONALE FOR UNBUNDLING AN INTEGRATED POSTAL NETWORK

A fully integrated postal network includes the following activities: (i) acceptance, (ii) mail processing and transportation, and (iii) delivery. The portion of the postal network that provides daily delivery service to every address in the country benefits from extensive economies of scale and scope. Hence that part of the network is viewed as having natural monopoly characteristics.[2] The activities of acceptance, as well as mail processing and transportation, on the other hand, are not subject to economies of scale or scope, nor do any natural barriers preclude entry by would-be competitors. They are fully contestable and can be separated easily from delivery. These activities thus qualify as candidates to be split off into an autonomous entity, which would be subjected to full competition, while leaving the natural monopoly delivery function to be operated by the postal administration and regulated by the government.

The basic rationale for unbundling a postal network, as stated by Elcano *et al.* (2000) is the "underlying economic premise that increased competition ... results in increased quality, efficiency, and lower prices to the consumer." No approach to unbundling will eliminate or reduce the scope of the natural monopoly over delivery. Given that fact, the most straightforward way to reduce the resources operating under the protective umbrella of monopoly is to distinguish between activities that can lay claim to natural monopoly (delivery) and all others that are contestable. Transfer of all contestable activities into an independent for-profit private entity would increase substantially the resources

---

[2] In the United States, this natural monopoly is reinforced by provisions in the law that (1) prohibit access to mailboxes by anyone other than USPS carriers (the so-called "mailbox rule"), and (2) give the USPS the exclusive right to carriage of low-priced letter mail. For information on the mailbox rule, see General Accounting Office (1997). For discussion about the nature and extent of economies of scale in delivery, *see* Cazals, *et al.* (2005a and 2005b) and the references cited therein.

subject to the discipline, risks and rewards of competitive markets, and the entity's need to survive would instill cost-minimizing and profit-maximizing incentives into a large segment of the existing postal network.

2. WHAT CONSTITUTES UNBUNDLING OF AN INTEGRATED POSTAL NETWORK?

In other network industries that historically were vertically integrated, such as telecommunications and electricity, unbundling of a firm is considered to have occurred after activities deemed to be potentially competitive were (i) restructured into a legal entity separate from those other activities that continued to function as a monopoly, and (ii) then spun off entirely, either to stakeholders or to a third party. The end result was that the continuing monopoly entity[3] ceased to exert any control over the newly-created competitive entity. Legal separation of firms with vertically integrated networks either created or helped to expand intermediate markets that, prior to unbundling, may have been nonexistent.[4] Creation of separate legal entities with different ownership interests also ensured that each restructured company would both (i) strive to be financially self-supporting and profitable, and (ii) independently set prices for

---

[3] Or "entities" in the case of the old AT&T, from which several regional monopolies were created, along with a competitive long-distance operator. Subsequent mergers in the telecom industry have resulted in a certain amount of "re-bundling." Nevertheless, the breakup of the old AT&T monopoly, coupled with technological developments (*e.g.*, cell phones, cable, the internet) have resulted in a much more competitive telecom sector.

[4] Intermediate markets created or expanded by virtue of unbundling have been mostly at the wholesale level.

their respective products or services at a level at least adequate to cover their own total costs.

In those industries where public policy has promoted unbundling, the stated objective was to achieve competitive efficiency, with prices of competitive services determined in competitive markets. Unbundling of a postal administration in the manner envisioned herein would ensure that prices of mail processing and transportation services were determined in competitive markets. The monopoly portion would publish prices for its delivery services, and would establish access prices (within each subclass) available for use by all upstream competitors.

It certainly is possible for a postal administration to provide downstream access to its network without in any way restructuring itself along the lines described above.[5] Currently, the USPS allows downstream access by giving mailers worksharing discounts, which correspond to implicit prices for upstream services. When prices are set in this way, however, they can differ significantly from those likely to result from complete unbundling and full competition, as

---

[5] The authors are not aware of any universally accepted definition of unbundling that necessarily requires the creation of separate legal entities, so long as the necessary economic characteristics are present — namely, autonomous price setting by financially self-supporting entities, a competitive sector with no barriers to entry by third-parties, and an essentially level playing field for all competitors. De facto unbundling might be obtainable simply by restructuring a postal administration into autonomous or quasi-autonomous self-supporting divisions. Restructuring of The Post Office in Great Britain into three components — The Royal Mail, The Parcel Force, and Counters — provides an illustration of the restructuring of a postal administration into quasi-autonomous, financially self-supporting units.

discussed in more detail below. This existing scenario will be referred to as a "partial liberalization" of rates, in order to distinguish it from a true separation of contestable activities.[6]

3. UNBUNDLING THE USPS

As the preceding discussion indicated, a postal administration can be unbundled, with mail processing and transportation separated from delivery by each being placed into separate units. The unit responsible for mail processing and transportation is referred to herein as the United States Mail Service ("USMS"). The other unit is referred to as the United States Delivery Service ("USDS").

The USMS would charge an explicit price for each mail processing and transportation service that it provides, and those prices would need to generate sufficient revenues to enable the USMS to be financially self-supporting. The USDS would charge explicit rates for delivery, with the same rates being paid by USMS and other mail providers. Thus, the charge for delivery could not subsidize mail processing and transportation, or vice versa.

Separating functions in the manner described herein would necessitate certain changes that are considered integral to unbundling and are discussed below. At the same time, a variety of other possible postal reforms, such as consolidating and transforming the retail network, revising the monopoly statues,

---

[6] For discussion of liberalization of postal markets, see Cohen, *et al.* (2001). Also see Crew and Kleindorfer (1995).

or changing the USO, are not integral to unbundling, and are not discussed further.[7]

Over time, full competition should reduce the cost and improve the quality of mail processing and transportation services, which would help to maintain — or even increase — the total volume of mail delivered by the USDS.

3.1 The U. S. Mail Service

The USMS would be responsible for performing all contestable activities "upstream" of delivery; *e.g.*, acceptance, barcoding of originating mail, inter-city transportation, and all sortation other than sequencing mail for final delivery by carriers. Since these upstream activities would be open to competition on a level playing field, and the USMS would have to be financially self-supporting, pricing of services provided by the USMS should be deregulated completely.[8]

---

[7] For discussion of other possible reforms, see Postal Service (2002), General Accounting Office (2004) and Campanelli (2002). The model described herein focuses exclusively on the feasibility and desirability of splitting into two separate entities an organization that has been vertically integrated for centuries, and is widely viewed as a unitary institution. The changes discussed are those deemed essential for unbundling to succeed. This paper does not seek to resolve every transitional or operational issue that would arise from a complete unbundling of upstream mail services. The purpose here is only to demonstrate that unbundling is operationally feasible, and that such issues would be manageable.

[8] See section 3.1.6, *infra*. The USMS would be subject to the same anti-trust laws as its competitors.

Because the USMS would necessarily function in a highly competitive environment, it is essential that no part of the USO be imposed on the USMS.[9] Every aspect of the USO should become the sole responsibility of the USDS. In order to survive and prosper, the USMS would need to be a lean, highly efficient operation, unencumbered by any significant requirement not also imposed on private sector competitors; *i.e.*, free of all restrictions placed on government agencies.[10]

3.1.1 USMS Ownership

Since an autonomous USMS would compete directly with the private sector, it should replicate a private sector ownership model, preferably as a stock company. Initially, ownership could reside directly with the government or the newly-created USDS. However, the most effective way to create a level playing field would be to privatize the USMS completely; *i.e.*, divest all of the stock. The initial owner would sell some or all of the USMS stock to the public, analogous to what the Dutch and German governments have done with their postal administrations.[11] So long as any ownership ties remain between the USMS and

---

[9] For more discussion on the USO, see Section 3.2.1, *infra*.

[10] In the United States, laws establishing restrictions on government agencies include compliance with the Davis-Bacon Act, veterans hiring preferences, etc.

[11] Proceeds from any privatization could be used to establish a reserve to pay unfunded liabilities of the USPS.

the government, absolute leveling of the competitive playing field would be a difficult proposition.[12]

Complete privatization also would be the most assured way to eliminate political influence over what should be straightforward business decisions.[13] So long as the government retains links to the USMS, the inevitable concentration of USMS employees around larger processing facilities potentially could constitute a formidable political force to pressure Congress to override sound economic decision making.

3.1.2 USMS Facilities

The USMS would be responsible for operating all of the USPS's existing plants and distribution facilities, but none of the retail or delivery offices. In an unbundled scenario, final sortation of mail into a carrier's route sequence would become a responsibility of the USDS. One obvious issue arises with respect to those facilities that now function in a dual capacity; *i.e.*, facilities that process

---

[12] Advantages of government ownership to USMS might entail exemption from all state and local taxes and fees. Offsetting such possible advantages, USMS employees might continue to be part of the federal retirement and health benefits system, and be covered by the federal workers compensation scheme. For further discussion on level playing field issues, see Gibbons (2005).

[13] The USMS could be structured as a quasi-autonomous Government Sponsored Enterprise ("GSE"). Complete privatization would be preferable, but creation of a GSE might be one way to transition to privatization. Although GSEs such as Fannie Mae and Freddie Mac have operated quite successfully over a long time span, it would be naive to think that political considerations do not affect their decision making.

originating, outgoing mail, as well as sorting certain destinating, incoming mail into delivery sequence for carriers (only letter mail is machine-sorted into a carrier's route sequence at present).

Initially, the issue of dual purpose facilities could be resolved in either of two ways. First, the USDS could contract with the USMS to use both its facilities and employees to continue sequencing destinating letter mail. Alternatively, the USDS could lease the space and equipment from the USMS during late night and early morning hours, and use its own employees to sort destinating (letter) mail into carrier sequence. Such alternative transitional arrangements could operate concurrently; *i.e.*, subcontracting in some locations, while subleasing facilities in other locations. If one of these transitional arrangements proved to be highly efficacious in a particular location, it might continue indefinitely. Otherwise, in major metropolitan areas the USDS should in time establish and operate its own centralized facilities, which would be used exclusively to accept and process destinating mail.[14]

As a competitive entity, the USMS would need to have complete operational flexibility with respect to opening, relocating, consolidating and closing all of its mail processing facilities. In other words, its facility decisions no longer would be influenced by political considerations, except to the extent that such considerations similarly impact decisions by other private companies such as DHL, FedEx, and UPS. Managerial freedom to control this part of the network

---

[14] See Section 3.2.3, *infra*, for further discussion.

is integral to unbundling. In view of the way political considerations have constrained such decision-making by the USPS, especially closure of existing plants, complete flexibility ought to provide the USMS with a net gain in efficiency.

3.1.3 USMS Transportation

The USMS would be responsible for moving such mail as it handles from point of entry to the appropriate USDS facility for delivery.[15] Consequently, all existing USPS contracts for inter-city and long-distance transportation would be transferred to and become the responsibility of the USMS. All trucks and other equipment currently used by the USPS to transport mail between processing facilities also would be transferred to and operated by the USMS.

As a competitive entity, the USMS would need to have complete flexibility with respect to negotiation of contracts with all transportation providers, including domestic and international airlines. Moreover, the USMS ought to be free to own and operate its own transportation equipment (as are FedEx, UPS and other competitors of the USPS), should that be deemed more cost-efficient. Such operational flexibility also is considered integral to unbundling, and should be another source of net efficiency gains by the USMS.

---

[15] Outgoing international mail would bypass the USDS delivery network and flow directly to other countries. Incoming international mail from other postal administrations would be received by the USDS, which would contract with the USMS to process, transport and distribute it to the appropriate USDS facilities for delivery.

3.1.4 USMS Employees

Following restructuring, many clerks and mail handlers now employed by the USPS would become employees of the USMS, along with supervisors of mail processing operations and the managerial staff of postal plants. Additionally, the infrastructure for letting and supervising transportation contracts also would become part of the USMS. Nationwide, the USMS initially could be expected to have over 200,000 employees. Of course, the USMS also would have its own management organization and overhead structure *(e.g.*, personnel department), entirely separate from that of the USDS.

3.1.5 USMS Operations

Standardized mailing requirements such as barcoding, electronic address verification, machine readability, packaging, etc., would be established by the USDS. The USMS would be required to prepare mail to meet the current entry requirements of the USDS on the same basis as any mailer or other third-party provider that enters mail directly with the USDS. It also would have to comply with any future requirements imposed on every party that submits mail to the USDS. This requirement to meet all current and future changes in mailing requirements imposed on other mailers is essential to creating a level playing field between the USMS and private sector competitors.

3.1.6 Pricing of USMS Services

Establishing the USMS as a separate entity would change the manner in which prices are determined for many commercial and nonprofit bulk mailers. Not affected, of course, would be those mailers which already bypass the entire upstream network and enter their mail at local USPS delivery units. For all other bulk mail, the USMS would charge separate, explicit prices for each of its various mail processing and transportation services (as other third-party intermediaries currently do). Any mailer that used USMS would pay those separate prices, in addition to paying the USDS rates established for delivery. The USMS would continue to accept bulk mail, just as it does today, and then provide it with such transportation or processing as may be necessary to enter it at destination facilities of the USDS.

One major difference is that prices for all USMS intermediate services would be unregulated.[16] Prices charged by the USMS for its services could be published or unpublished, uniform or nonuniform, negotiated or not subject to negotiation, as the USMS sees fit. As a de-regulated entity, the USMS could change its prices whenever it elected to do so. Of course, all intermediate services provided by the USMS would be totally open to competition, so if the

---

[16] Classification distinctions would continue to exist for the USDS (see Section 3.2.8, *infra*). However, since USMS would be a competitive, financially self-supporting entity, classification distinctions would cease to be imposed on the USMS. It would have no more obligation than FedEx, UPS or other competitors to offer any kind of discount or other special price consideration for services provided to nonprofits, periodicals, parcels, or any other mailers that heretofore have received favored treatment.

USMS charged prices for some services that exceeded the value of those services, it thereby would encourage competitors to offer those services at a lower price.

For First-Class bulk mail, for example, the USMS could use its pricing freedom to charge a price that, when added to the rate for delivery, would equal the uniform rate charged for single-piece mail, but only if it so elected. Offsetting this price setting freedom for the USMS would be the requirement for the USDS to establish a downstream access price for all bulk First-Class Mail. Any attempt at aggressive pricing of bulk First-Class Mail by the USMS would attract considerable competition — like “bees to honey.” Over time, competition can restrain and establish prices more effectively than regulation. Thus, for First-Class bulk mail the USMS presumably would establish its prices so as to keep bulk mailers’ unit cost lower than the rate for single-piece mail, reflecting the fact that less work is required to process such mail.

Prices of USMS services would need to be sufficiently high for the organization to recover its stand-alone costs. Initially, the cost structure of USMS would include all existing attributable costs of mail processing and transportation,[17] as well as all overhead costs necessary to operate as a separate, independent organization. The USMS necessarily would assume

---

[17] The Postal Rate Commission already treats most mail processing and transportation costs as attributable, and those costs are reflected in the existing rates for each respective subclass of mail. In 2004, attributable mail processing and transportation costs, including indirect costs, amounted to approximately $25 billion. USMS revenues could be expected to exceed this amount.

responsibility for some portion of the USPS's (non-attributed) overhead costs, thereby reducing the overhead burden on the USDS (and allowing prices charged for delivery by the USDS to be reduced accordingly).

For example, the USMS would have its own senior executives and all attendant headquarters staff functions, such as legal, procurement, etc. Also, any costs of supervising, managing and maintaining major facilities which currently are not attributed would become part of the overhead of the USMS. Similarly, although most transportation costs are attributed, any not now attributed also would become overhead costs of the USMS.[18] Although these overhead costs may not be attributable to any single class or subclass of mail, they relate directly to the upstream services provided by USMS. Consequently, they are part of the incremental cost of providing mail processing and transportation service, and would need to be recovered via a markup on the attributable costs of those services, as they no longer would be recoverable through a markup on the cost of delivery.[19]

---

[18] Accordingly, non-attributable costs of the USMS likely would be low in comparison to current system-wide non-attributable costs, which are reckoned to be somewhere in the range of 36 to 42 percent of total costs. As a rough estimate, residual costs of the USMS might be expected to range anywhere from as little as 10, to as much as 20, percent of its total costs.

[19] As an independent entity, the USMS would need to have some means of determining the cost of each individual service that it offers. It might not opt to continue using attributable costs as currently defined. References to attributable costs here are a proxy for whatever other cost scheme the USMS might devise.

Since pricing of USMS services would have to generate funds sufficient to recover stand-alone costs, some (perhaps many) of the explicit prices charged by the USMS for its mail processing services would need to exceed the current USPS implicit prices (*i.e.*, discounts) that have evolved under partial liberalization. Limiting such discounts to no more than avoided attributable costs means that on average USPS implicit prices fail to recover the full incremental cost of the services provided, quite unlike competitive pricing.[20]

The asserted rationale for limiting worksharing discounts has been the Efficient Component Pricing ("ECP") rule.[21] The ECP rule seeks to emulate competitive pricing within a regulated setting. It clearly states that prices for competitive services should equal average-incremental cost, which is neither the same as, nor equal to, attributable cost. Consequently, discounts that reflect only avoided attributable costs should not be viewed as conforming with the ECP rule found in the published literature.[22]

---

[20] Implicit prices for mail processing and transportation, in the form of worksharing discounts, fail to cover the USPS's own costs of doing the same work for which discounts are given; see Haldi and Olson (2003).

[21] For an explanation of ECP, see Baumol and Sidak (1994). For a critique of ECP, see Economides and White (1998) and Economides (2003). For a basic discussion of worksharing, see General Accounting Office (2003) and the references cited therein.

[22] Nowhere does the published literature on ECP make any reference to attributable cost, which is a term of art unique to the USPS. The ECP rule does not provide a rationale or theoretical support for any "rule" or pricing paradigm that limits worksharing discounts to attributable cost.

For upstream postal services, complete unbundling and abolition of all regulation is the only guaranteed way to assure competitive pricing. Unbundling would necessitate that the USMS charge competitive market prices that reflect the long-run marginal cost of services provided. Such market prices are likely to differ from implicit prices (*i.e.*, discounts) that are based solely on attributable costs. Achieving the type of efficiency gains that come only from full competition will require that USMS prices for its different mail processing services be driven, over time, to the level of long-run marginal cost and competitive equilibrium.[23] Moreover, it is reasonable to expect that prices would be driven to long-run marginal cost in short order, since numerous "hungry" competitors already exist.[24]

3.2 The U. S. Delivery Service

The "downstream," or delivery, portion of the postal network would be by far the largest component of the USDS, along with retail outlets and various ancillary services. The USDS would accept mail for delivery at designated acceptance units. In general, all Destination Delivery Units (DDUs) would serve as acceptance units. In addition, in urban areas the USDS might establish its

---

[23] Competitive private sector firms typically price their services on the costs which they incur to provide those services. An unbundled USMS, when setting prices for its services, likely would be forced to focus more on costs incurred to provide each service, and less on costs avoided.

[24] Many of the firms that now provide intermediary postal services are fairly substantial in their own right; *e.g.*, UPS, FedEx, DHL, Pitney Bowes (PSI Presort), R.R. Donnelley, Quad Graphics, QuebecorWorld, etc.

own centralized bulk mail acceptance units to service nearby DDUs. All bulk mail accepted directly by the USDS would be required to meet stated mail make-up requirements, including minimum quantities.[25] Mail would be accepted at published rates (see Section 3.2.8, *infra*) from (i) the USMS, (ii) any firm or organization that enters its own mail, (iii) any letter shop or printer that prepares mail on behalf of others, or (iv) presort bureaus, consolidators or any other third-parties providing intermediary sorting and transportation for mailers seeking better service and/or lower rates.[26]

Responsibility for meeting all aspects of the existing universal service obligation ("USO") would fall solely to the USDS (see Section 3.2.1, *infra*). To help the USDS finance its USO, the USDS would retain the existing statutory monopoly, which would be neither enlarged nor reduced.

In view of the USDS monopoly on delivery of letter mail, all of its rates and fees for delivery would continue to be regulated by the Postal Rate Commission ("PRC"). The PRC would be charged with assuring that all USDS rates, fees, and other terms are fair and non-discriminatory, and do not favor any particular competitor or restrict competition among those that provide mail to the USDS. Rates and classifications, as they pertain to delivery, could continue to be set as

---

[25] For purposes of the exposition here, we assume that the existing minimums for bulk mailings remain in effect.

[26] Any firm that entered mail directly with the USDS would be viewed as a customer of the USDS. It also could be viewed as "partnering" with the USDS, as described by Elcano *et al*. (2000) and Bizzotto (2003). However, firms that entered mail directly with the USDS would be viewed by the USMS as competitors.

they are today; *i.e.*, by means of a formal adversarial rate proceeding.[27] In its regulation of the USDS, the PRC's responsibility would be to protect competition, but not any individual competitor, including the USMS.

3.2.1 The Universal Service Obligation and Single-Piece Mail

The USO consists of the following elements: (1) daily delivery of mail to every route, regardless of volume; (2) daily collection of mail from all collection boxes; (3) operation of the retail network; and (4) a uniform rate for single-piece letters. It is assumed here that the USO would continue unchanged. The USDS would be responsible for providing all four elements of the USO.[28] Since each part of the USO has unprofitable components (*e.g.*, unprofitable delivery routes, collection routes, or retail post offices) that a private enterprise firm might be motivated to reduce or eliminate, the monopoly is bestowed on the organization that must fulfil the USO.

Single-piece mail includes all letters, flats and parcels mailed by individual members of the public. Single-piece mail necessitates the expenses incurred to pick up mail from collection boxes and individual mail boxes, and operate the

---

[27] As noted previously, the USMS would be unfettered by any kind of classification or rate regulation. For the USDS, although other rate-setting procedures, such as rate indexing, could be used, changing the manner in which rates for delivery are established is neither integral nor a prerequisite to unbundling.

[28] The regulator could be charged with oversight for any or all aspects of the USO. In the United States, for example, closure of small post offices can be appealed to the regulator.

retail network. Responsibility for single-piece mail thus is viewed as an integral part of the USO, hence is the province of the USDS. The general public would interface solely with the USDS, both at local postal retail facilities and at point of delivery. The USDS therefore would be responsible for meeting all service standards.

Initially, the USDS would contract with the USMS to process and then transport single-piece mail to DDUs, the same service it performs today.[29] However, if the USMS failed to control its costs or meet service standards, the USDS could contract with other independent vendors to process and transport some, or even all, single-piece mail.[30] At the outset, the USMS might be able to dominate the contracting relationship, at least for processing of ordinary single-piece letters. With respect to Express Mail, Priority Mail and parcels, however, even from the outset the USDS could consider contracting with others, such as DHL, FedEx, or UPS.

3.2.2 USDS Ownership

The USDS would continue to be owned and operated by the government. The governance structure of the USDS could be the same as the USPS, with a

---

[29] To provide the USMS with a stable transition, the initial contract might be for an extended period, such as five or more years.

[30] Any contract for processing of single-piece mail would contain provisions to assure privacy and limit the maximum allowable time for the contractor to process and transport the mail. In 1997, the USPS entered into such a contract for processing and transporting of Priority Mail.

governing board appointed by the President and confirmed by the Senate. In turn, the governing board would be responsible for hiring the top full-time executives, who would serve at the pleasure of the governing board. The USDS would have a financial break-even requirement, similar to the existing requirement for the USPS.[31]

3.2.3 USDS Facilities

The USDS would own (or lease) and operate all retail facilities. It would rent post office boxes to the general public, and deliver mail to those boxes. It also would be responsible for all means of distributing and selling stamps, such as operation of any free-standing kiosks and all contract post offices. The USDS also would own (or lease) and operate any destinating delivery units (DDUs) that are not part of a retail post office. As indicated under the preceding discussion of USMS facilities (section 3.1.2), plants would continue to process both originating and destinating mail unless and until the USDS decided to acquire and operate its own centralized, dedicated acceptance units in metropolitan areas.[32]

---

[31] Subsidies might exist for free-for-the-blind mail. Any such subsidy, however, is for the benefit of blind persons, not to help support the USDS.

[32] Having dedicated acceptance facilities that process only destinating mail at first blush may appear redundant. However, equipment and space costs are rather small in comparison to postal labor costs, and separate facilities would help reduce congestion at loading docks. Having separate facilities for outgoing and incoming mail even might improve service by reducing the volume of mail that somehow becomes temporarily displaced, but ultimately gets delivered,

(continued...)

3.2.4 USDS Transportation

The USDS would have no responsibility for inter-city transportation of mail. At most, it would be responsible for moving mail from a local, centralized acceptance unit to nearby DDUs; hence, all contracts for intermediate and long-distance transportation would remain with the USMS.[33] At the same time, all delivery vehicles currently operated by USPS carriers, as well as trucks currently used for collection of mail and local transportation between centralized metropolitan destination facilities and DDUs — would remain with the USDS.

3.2.5 USDS Employees

All city and rural carriers would be employees of the USDS, as would their supervisors, as well as clerks and mailhandlers needed to oversee, accept or handle mail at DDUs and any other facility operated by the USDS. Postmasters, retail clerks, and contract carriers also would be part of the USDS. As an independent entity, the USDS would have its own management organization and overhead structure. This would include the Inspection Service, data processing centers, addressing services (see next section), etc. USDS employees would number in the hundreds of thousands.

---

[32](...continued)
days or even weeks late.

[33] For single-piece mail, USDS would collect the full amount of postage, and then contract for it to be processed and transported. The sole contractor, at least initially, would be the USMS.

3.2.6 USDS Ancillary Services

The USDS would own, operate and maintain all address correction services. These would be made available to all users on the same basis. Any fees for use of such services would be paid by the USMS on the same basis as others.

3.2.7 USDS Attributable and Residual Costs

The portion of the postal network which must provide daily delivery to virtually every route in the country, regardless of volume, has relatively high non-attributable (fixed or residual) network costs in comparison to attributable (predominately volume variable) costs. In general, postal delivery benefits from economies of scale and scope. These cost characteristics underlie the delivery network's claim to natural monopoly status.

For the USPS as a whole, non-attributed costs have ranged between 36 and 42 percent of total costs. As indicated previously, the USMS would assume some unattributed overhead costs, so the entire burden of existing overhead costs would not be incurred by the USDS. Nevertheless, after unbundling the USMS, the residual non-attributed overhead costs of the USDS likely would constitute more than 50 percent of its total costs. This means that, in order for the USDS to cover the residual non-attributed portion of its cost structure, the systemwide markup on attributable delivery cost would need to exceed 100 percent.

3.2.8 USDS Rates, Acceptance and Payment

All rates for single-piece mail would be set by the PRC. As a matter of public policy, the PRC would be required by statute to recommend a uniform rate for single piece letters, as it does now. Retail customers would be unaffected by unbundling in the manner described here.

One major change is that the PRC would be required to recommend a rate for delivery of bulk First-Class Mail entered at destination facilities of the USDS; *i.e.*, a downstream access price for bulk First-Class Mail. This would provide an incentive not only for drop shipping, but also for electronic transmission coupled with local printing and entry.

For purposes of this discussion, it is assumed that the existing classification structure would continue in effect. That is, the rates for delivery would continue to distinguish between private correspondence, periodicals, for-profit and non-profit advertising mail, and packages, as they do now. The USDS rates for delivery would be determined by the PRC in accordance with criteria contained in the Postal Reorganization Act. These criteria would result in some products having higher markups, while others would have lower markups, as is the case now. However, PRC-established markups would apply only to attributable delivery cost.

All intermediaries that handle bulk mail for others, including the USMS, would know that they must pay the USDS's published rates for delivery, adding to those rates their charge for such intermediate services as they provide. As worksharing discounts now are limited generally to attributable cost, to the extent that the USMS became responsible for a portion of the existing pool of non-attributed overhead costs, rates for delivery would be reduced below existing levels. Collectively, rates charged by the USDS would need to cover its stand-alone costs. At the same time, as a result of divestiture, no USDS revenues could be used to enable the USMS to charge lower prices for any of its competitive services.

All mail tendered to the USDS for delivery, including all mail tendered by the USMS, would be subject to meeting uniform published standards, and would be subject to inspection and verification before being accepted.

The USDS would collect the appropriate rates from each organization that tendered bulk mail to it for final delivery, including the USMS.[34] That is, whenever a mailer tendered its own bulk mail directly to USDS, it would make a direct payment to the USDS.[35] Whenever an intermediary (including USMS) tendered the mail of a business firm or nonprofit organization, the intermediary would be responsible for all payments due to the USDS. The intermediary would charge the mailer a price for all services rendered by the intermediary plus the full amount charged for delivery by the USDS.

---

[34] If the USMS were to be restructured as an autonomous unit within the USPS, such payments would constitute transfer fees. Any such fees paid by the USMS should be identical to those charged to independent third parties; see Panzar (2002) for more discussion on this topic.

[35] In the case of single-piece mail, USDS would collect the full amount of postage, and payment would flow from USDS to its contractor(s), which initially would be only the USMS.

4. ADVANTAGES OF UNBUNDLING AN INTEGRATED POSTAL NETWORK

Unbundling would maximize downstream access opportunities while preserving the USO. After unbundling, existing delivery, retail and collection networks would function uninterrupted, daily universal delivery service would continue unchanged, and single-piece letters would continue to be charged a uniform rate. Given this unbundling alternative, the current status quo, described previously as partial liberalization of rates, should be seen as be an unnecessary compromise with competitive standard.[36]

From the preceding discussion, it should be apparent that an upstream entity, such as USMS, is not integral to providing or preserving any aspect of the USO. Should the upstream entity fail to operate competitively, it could be replaced seamlessly by more efficient private sector competitors. Regardless of whether the upstream entity or its competitors prevail in the marketplace, using the competitive model to maximize efficiency in mail processing and transportation would increase mail volume and sustainability of the existing USO.

Subjecting upstream services to the full rigors of a competitive market necessitates giving management complete flexibility over the upstream portion of

---

[36] The threat of a postal death spiral is not considered in this paper. It is of interest to note, however, that Crew and Kleindorfer (2005), after examining several access and entry policies, found partial liberalization, with final delivery retained by the postal administration, to be the "safest policy" from the postal administration's point of view; *i.e.*, the policy most likely to avoid a death spiral. Crew and Kleindorfer did not examine the unbundling and full competition model described herein. Had they done so, they might have found it an even better way to advance de-regulation while preserving the USO.

the postal network. Thus freed, management at last would be able to reshape and improve the mail processing network without costly political constraints.[37] Importantly, it also would have strong, market-based incentives to do so.

Complete unbundling should be accompanied by total deregulation of pricing for upstream postal services for all bulk mail. All upstream services should be fully open to competition. Since the upstream entity would have to be self-supporting, it would need to price its services so that, collectively, the organization would recover its stand-alone costs. With the upstream entity no longer immune from the anti-trust laws, competition would drive prices to their long-run marginal cost, thereby protecting bulk mailers from monopolistic price-gouging. The USPS has resisted efforts to offer destination entry prices for bulk First-Class Mail. Having an unbundled delivery unit offer such prices not only would promote competition, but also would be an important efficiency-enhancing change that is long overdue.

It is submitted that unbundling upstream services and opening them to full competition on a level playing field constitutes the most significant and salutary reform possible in the current political climate. The increase in efficiency that could flow from such unbundling would likely be on par with, and even might exceed, increases in efficiencies that could be obtained from other proposed major reforms, such as reducing the number of delivery days required by the USO (*e.g.*, from 6 to 5 days per week in the United States), or reforming the

---

[37] Imposing such constraints could doom an otherwise competitive USMS to economic failure.

retail sector (*e.g.*, closure or relocation of 20,000 to 25,000 existing USPS retail outlets).

The discussion here has demonstrated how an unbundling policy could be applied to the USPS, the world's largest postal administration. It should be clearly understood, though, that unbundling offers an important policy option for any country that desires to increase the level of competition in the postal sector. It should be an especially attractive option wherever a postal administration, for whatever reason, is encumbered by a high-cost mail processing operation. Inevitably, providing support for such high-cost operations imposes an unnecessary burden on the delivery portion of the postal network. This economically desirable and politically achievable approach deserves serious consideration in ongoing discussions about postal reform.

References

Baumol, William J., and Gregory Sidak. 1994. "The Pricing of Inputs Sold to Competitors." Yale Journal on Regulation, Vol. 11, No. 1 (Winter, 1994), pp. 171-202.

Bizzotto, Anita. 2003. "Postal Worksharing: A Partnership with Our Customers," statement presented to the Presidential Commission on the U. S. Postal Service.

Campanelli, John. 2002. "The USPS – What Needs to Be Done." In Mailing Systems and Technology, Vol. 14, No. 3 (March-April, 2002) pp. 34-37.

Cazals, Catherine, Frédérique Fève, Jean-Pierre Flourens and Bernard Roy. 2005a. "Delivery Costs II: Back to Parametric Models," in *Regulatory and Economic Challenges in the Postal and Delivery Sector,* edited by Michael A. Crew and Paul R. Kleindorfer. Boston, Mass.: Kluwer Academic Publishers.

Cazals, Catherine, and Jean-Pierre Flourens and Soterios Soteri. 2005b. "Delivery Costs for Postal Services in the U.K." in *Regulatory and Economic Challenges in the Postal and Delivery Sector,* edited by Michael A. Crew and Paul R. Kleindorfer. Boston, Mass.: Kluwer Academic Publishers.

Cohen, Robert H., William W. Ferguson, John D. Waller and Spyros S. Xenakis. 2001. "The Impact of Using Worksharing to Liberalize a Postal Market," United States Postal Rate Commission. Washington, DC. mimeo, paper presented at 6th Koenigswinter Seminar on Postal Economics "Liberalization of Postal Markets" (February 19–21, 2001).

Crew, Michael A. and Paul R. Kleindorfer. 1995. "Pricing in Postal Service under Competitive Entry." In *Commercialization of Postal and Delivery Services: National and International Perspectives,* edited by Michael A. Crew and Paul R. Kleindorfer. Boston, MA: Kluwer Academic Publishers.

Crew, Michael A. and Paul R. Kleindorfer. 2005. "Competition, Universal Service, and the Graveyard Spiral," in *Regulatory and Economic Challenges in the Postal and Delivery Sector,* edited by Michael A. Crew and Paul R. Kleindorfer. Boston, Mass.: Kluwer Academic Publishers.

Economides, Nicholas and Lawrence J. White. 1998. "The Inefficiency of the ECPR Yet Again: A Reply to Larson," *Antitrust Bulletin Vol. 43, p. 429.*

Economides, Nicholas. 2003. "The Tragic Inefficiency of the M-ECPR," in *Down to the Wire: Studies in the Diffusion and Regulation of Telecommunications*

Technologies, edited by A. Shampine. New York, NY.: Nova Science Publishers, Inc.

Elcano, Mary S., R. Andrew German and John T. Pickett. 2000. "Hiding in Plain Sight: The Quiet Liberalization of the United States Postal System." In *Current Directions in Postal Reform*, edited by Michael A. Crew and Paul R. Kleindorfer. Boston, MA: Kluwer Academic Publishers.

General Accounting Office. 1997. *U. S. Postal Service: Information About Restrictions on Mailbox Access.* GAO/GGD-97-85 (May, 1997).

General Accounting Office. 2003. *U. S. Postal Service: A Primer on Postal Service Worksharing.* GAO-03-927 (July, 2003).

General Accounting Office. 2004. *U. S. Postal Service: Bold Action Needed to Continue Progress on Postal Transformation.* GAO-04-108T (Washington, DC: November 8, 2003).

Gibbons, Mary Anne. 2005. "Universal Service Providers: Defensive Moves on the Level Playing Field, " in *Regulatory and Economic Challenges in the Postal and Delivery Sector,* edited by Michael A. Crew and Paul R. Kleindorfer. Boston, Mass.: Kluwer Academic Publishers.

Haldi, John and William J. Olson. 2003. "An Evaluation of USPS Worksharing: Postal Revenues and Costs From Workshared Activities," in *Competitive Transformation of the Postal and Delivery Sector,* edited by Michael A. Crew and Paul R. Kleindorfer. Boston, Mass.: Kluwer Academic Publishers.

Mitchell, Robert W. 1999. "Teaming Up with the USPS to Save Money and Increase Efficiency," in *Mailing Systems Technology*. May/June 1999, pp. 28-33.

Panzar, John C. 2002. "Reconciling Competition, Downstream Access, and Universal Service in Postal Markets." In *Postal and Delivery Economics: Delivering on Competition,* edited by Michael A. Crew and Paul R. Kleindorfer. Boston, Mass.: Kluwer Academic Publishers.

Postal Service. 2002. *Transformation Plan* (April, 2002).

Rogerson, Cathy M. and David E. Treworgy. 1994. "Refocusing the U. S. Postal Service Monopoly." (mimeo; presented at Fourth Conference on Postal and Delivery Economics, Saltsjöbaden, Sweden).

Valletti, Tommaso M. and Antonio Estache. 1998. "The Theory of Access Pricing: An Overview for Infrastructure Regulators." (March, 1998.) The World Bank Institute. Washington, D.C. and European Center for Applied Research in Economics. Brussels.