



The Global Competition Law Centre Working Papers Series

GCLC Working Paper 01/05

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American and European Perspectives After the Presidential
Commission and *Flamingo Industries***

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The Future of the U.S. Postal Service: American and European Perspectives After the Presidential Commission and *Flamingo Industries*

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Abstract

*In December 2002, President Bush established the Presidential Commission on the United States Postal Service for the purpose of proposing how government provision of mail delivery services might be reformed or transformed. The Commission reported in July 2003 that the Postal Service should not be privatized but rather should remain a public entity that would increasingly be run like a commercial enterprise. In 2004, however, the Supreme Court moved the Postal Service farther away from being a true commercial enterprise when it held in the *Flamingo Industries* case that the agency is immune from antitrust law. In this article, we argue that the Postal Service already operates like a commercialized governmental enterprise and that pursuing that path even further would increase rather than decrease the problems faced by the U.S. postal sector. Although we support privatization, that option may not be politically feasible. Consequently, we examine how postal reform might proceed incrementally in the form of an improved government agency. That approach would entail two broad principles for postal reform. The first is to define the Postal Service's mission in terms of remedying conditions of market failure. That goal encompasses universal service, quality of service, and reasonableness of rates. The second broad principle is to avoid competitive distortions through the pricing and product offerings of the Postal Service. This principle entails avoiding government production in markets that are or can be served satisfactorily by private firms, as well as avoiding discrimination among mailers and among competitors in secondary markets. We then present specific recommendations that would advance these two broad goals if the Postal Service remains an agency of the federal government. Those recommendations encompass costing, universal service, rate design and mail classification, the postal monopoly, and market entry and exit—as well as legislative reversal of *Flamingo Industries*.*

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I. Introduction

In December 2002, President Bush established by executive order the Presidential Commission on the United States Postal Service.¹ The Commission's mandate is "to examine the state of the United States Postal Service, and to prepare and submit to the President a report articulating a proposed vision for the future of the United States Postal Service and recommending the legislative and administrative reforms needed to ensure the viability of postal services."² Among the topics that President Bush specifically instructed the Commission to evaluate are pricing, service quality, cost control, the effects of price regulation, universal service, the postal monopolies, competition against private firms, and governance and oversight of the Postal Service.³ The Presidential Commission released a 208-page report in July 2003.⁴ As of mid-2004, the Bush administration was still considering which path, if any, to take to revitalize the U.S. Postal Service.

A few months before the Presidential Commission was constituted, the Postal Service itself produced an inch-thick report in April 2002 called the *Transformation Plan*.⁵ This document outlined three alternative models for the Postal Service.

1. Exec. Order, Dec. 11, 2002, available at <http://www.ustreas.gov/press/releases/reports/executiveorder.pdf> [hereinafter *Executive Order*].

2. *Id.* § 3(a).

3. *Id.* § 3(b). The Executive Order stated in section 3(b): "In fulfilling its mission, the Commission shall consider the following issues and such other issues relating to the Postal Service as the Commission determines appropriate:

- (i) the role of the Postal Service in the 21st century and beyond;
- (ii) the flexibility that the Postal Service should have to change prices, control costs, and adjust service in response to financial, competitive, or market pressures;
- (iii) the rigidities in cost or service that limit the efficiency of the postal system;
- (iv) the ability of the Postal Service, over the long term, to maintain universal mail delivery at affordable rates and cover its unfunded liabilities with minimum exposure to the American taxpayers;
- (v) the extent to which postal monopoly restrictions continue to advance the public interest under evolving market conditions, and the extent to which the Postal Service competes with private sector services; and
- (vi) the most appropriate governance and oversight structure for the Postal Service.

Id. The President directed the Commission to submit a final report by July 31, 2003. *Id.* § 4(e). To that end, the President empowered the Commission to hold public hearings and otherwise receive information from interested parties in both the public and private sectors. *Id.* § 5.

4. PRESIDENTIAL COMMISSION ON THE UNITED STATES POSTAL SERVICE, EMBRACING THE FUTURE—MAKING THE TOUGH CHOICES TO PRESERVE UNIVERSAL MAIL SERVICE (July 2003) [hereinafter PRESIDENTIAL COMMISSION].

5. U.S. POSTAL SERVICE, TRANSFORMATION PLAN (Gov't Printing Office 2002) [hereinafter TRANSFORMATION PLAN].

At one end of the spectrum of possibilities, the *Transformation Plan* suggests that the “Postal Service could be restructured as a Government Agency and focused on services that private companies cannot provide profitably, at least at prices and on the universal scale that policymakers deem appropriate to the needs of the United States.”⁶ For the Postal Service, this model would represent one possible approach to resolving the conflict between two policy objectives implicit in current postal law: ensuring universal service and promoting competition in the delivery services market. As a Government Agency, the Postal Service would thus “concentrate more on its role as an essential government service—somewhat similar to defense, the national park system, and the interstate highway system—and concern itself less with markets where customer requirements are already being addressed by the private sector.”⁷ Under this model, the Postal Service would have to reassess its products and services, potentially eliminating a number of services currently offered and adjusting the workforce to the attendant reduced mail volume.

At the other end of the spectrum of options, the *Transformation Plan* refers to “the possibility of complete transformation of the Postal Service into a shareholder-owned, value-maximizing company.”⁸ Under this model, Postal Service managers would be given a full range of private sector managerial tools and they would be placed under the supervision of a board of directors representing private shareholders. As a privatized corporation, the Postal Service would offer competitive products and services. Universal service would be provided under contracts negotiated between a regulator and various operators, including the privatized corporation. The privatized corporation would be able to implement market-based pricing, discounts and incentives, and private sector financial practices.

Finally, a mid-range approach would be “to transform the Postal Service into a Commercial Government Enterprise as a way to introduce an updated, stable business and financial model suited to the 21st century.”⁹ Under that model, the Postal Service would retain the provision of universal service. However, to allow this commercial government enterprise (CGE) to be in a position to best serve the public, the latter should be provided with the management tools available to commercial entities to assure more efficient and economical performance. As a commercialized entity, the Postal Service would be expected

6. *Id.* § 3.

7. *Id.*

8. *Id.*

9. *Id.*

to provide traditional and non-traditional products and services, implement market-based pricing, and adopt more commercial financing.

The Postal Service expressed a preference for the third option. According to the *Transformation Plan*:

“Postal Service leadership has concluded that the model of a Commercial Government Enterprise offers the best hope for transforming the Postal Service into an enterprise equipped to maintain universal service at affordable prices in the economy of the 21st century. The Postal Service’s basic mission will not change. Its corporate vision will continue to embrace delivery and access for every American. Increased flexibilities inherent in the Commercial Government Enterprise will afford opportunities for growth and cost containment. Although the value of the monopoly is diminishing, transformation of the Postal Service as a Commercial Government Enterprise will equip it to control costs and adapt to changing markets while continuing to provide universal service.”¹⁰

The Presidential Commission’s recommendations seem to echo those of the *Transformation Plan*. As the Postal Service did, the Commission disfavored privatization of the Postal Service because it would “pose a substantial risk of doing great harm.”¹¹ As proponents of privatization, we find this concern to be overblown on economic grounds but informative from a political perspective.¹²

Given its resistance of privatization, the Commission concluded that the Postal Service should remain a public entity but be “refocused and reorganized to enhance its efficiency and adaptability in the face of an uncertain, and ultimately more competitive, future.”¹³ With that aim in mind, the Commission proposed, among other things, the establishment of a corporate-style board of directors whose “overriding mission would be the transfor-

10. *Id.*

11. PRESIDENTIAL COMMISSION, *supra* note 4, at 18.

12. Privatization of the Postal Service remains our preferred option. *See, e.g.*, J. GREGORY SIDAK & DANIEL F. SPULBER, *PROTECTING COMPETITION FROM THE POSTAL MONOPOLY* (AEI Press 1996). One of us strongly advocated privatization while at the Council of Economic Advisers during the second term of the Reagan administration, only to encounter resistance from the Office of Management and Budget, for which privatization’s potential fiscal harms dominated consideration of its probable benefits in consumer welfare. Given the reality of such political resistance (coming as it did from an agency staffed with deregulatory economists during a conservative administration that generally praised privatization), consideration of second-best alternatives nearly twenty years later is only sensible. Today, if privatization remains politically unattainable, a return to the government agency model appears the preferable of the two remaining options.

13. PRESIDENTIAL COMMISSION, *supra* note 4, at 18.

mation of the Postal Service into an enterprise that consistently rivals the private sector in terms of the key benchmarks of cost reduction and quality of service.”¹⁴

Both the Postal Service and the Presidential Commission thus seem to converge around the third option—transformation of the Postal Service into a commercial government enterprise. But is such change needed to revitalize the Postal Service? A strong case can be made that the Postal Service already operates as a public service government agency in name only. In other words, the operations of the Postal Service today may have strayed so far from the agency’s legislative mandate, and the enterprise may be so immune from effective oversight by any political entity, that it is most appropriate to say that the Postal Service enjoys the privileges and immunities of its governmental status without bearing the full public service responsibilities that are the justification offered for such status.

The Postal Service’s current desire to be transformed into a commercial government enterprise would simply continue an existing trend. If the challenge of postal reform is seen from that perspective, then the Postal Service’s problems are evidence of the undesirability of organizing it *as a commercialized government enterprise*; those problems are not necessarily evidence that the Postal Service would be unable to improve its performance if it operated as a government agency that in fact sought to discharge at the lowest cost a highly focused public-service mandate. In that sense, the challenge of postal reform is not to transform the Postal Service into a completely new kind of enterprise, but rather, if privatization is not currently a politically acceptable option, to return the agency to what Congress intended it to be.

Relatively little public policy analysis has focused on the first of these three options, improving the Postal Service as a public service government agency. It is therefore useful to answer the following question: If one starts with the assumption that postal reform will take the form of making a better government agency, what policy changes should be adopted for the Postal Service? This exercise regards the Postal Service as a public service that Congress said “shall be operated as a basic and fundamental service provided to the people by the Government of the United States, authorized by the Constitution, created by Act of Congress and supported by the people.”¹⁵ The analysis presumes that Congress will continue to give the Postal Service the statutory mission to “bind the Nation together through the personal, educational, literary, and business

14. *Id.* at 38.

15. 39 U.S.C. § 101(a).

correspondence of the people.”¹⁶ Implicit in this public service model is the continuation of the Postal Service’s various monopolies and its universal service obligation (USO). Again, we emphasize that we are examining a second-best outcome in which privatization does not occur.

It is useful to imagine a “better” Postal Service because policymakers might rationally prefer government provision of postal services to other obvious alternatives. There are at least three economic reasons why this could be so. First, although economists tend to ignore the possibility, consumers may place considerable value on having certain postal services supplied by an arm of the federal government. Consumers may have these preferences notwithstanding the economic benefits that economists predict would flow from privatization of a typical state-owned enterprise. The decision after the September 11th terrorist attacks to take airport security screening away from private contractors and entrust it to the new Transportation Safety Administration may be an example of this kind of consumer preference. Economists routinely say, “You can’t dispute tastes.” If that is so, then it is neither consistent nor practical to deny that consumers may prefer to have an employee of the federal government coming onto their property to deliver mail that may contain confidential personal information, checks, and other sensitive matter. Perhaps this preference, to the extent that it exists, is rooted in consumer ignorance about the alternatives. If so, then more ambitious postal reform cannot proceed until public education and persuasion has first freed consumers of their naïveté. But such a campaign seems an unlikely one for Congress or the President to undertake.

Second, no matter how good a proposed restructuring of the Postal Service looks on paper, the recent experience from other network industries—such as telecommunications, electricity, and airlines—is a reminder that large-scale policy initiatives can produce unintended consequences that are worse than the status quo. It should not be surprising, therefore, if Congress and the President prefer to approach postal reform incrementally. That is not to say resignedly that more ambitious reformation or transformation of the Postal Service is impossible. Rather, a preference among policymakers to undertake incremental reform may be an acknowledgment that “ideal” policy initiatives of a more ambitious nature often reveal themselves to contain warts, and that experienced politicians consequently are leery of them.

A third and related hypothesis is the most obvious public choice explanation: Politics may constrain the feasible set of outcomes in the sense that one or more interest groups

16. *Id.*

may have the political influence to block more expansive change, such as privatization.¹⁷ This possibility is especially plausible in the case of the Postal Service. It has 800,000 voters in its work force, and Congress regularly enacts omnibus appropriations bills that contain riders prohibiting the closure of specific post offices, typically in small towns.

One could, of course, argue that opting for the governmental agency model is a backward-looking, unambitious approach. However, what we are proposing is a “new and improved” Postal Service, and the critical changes that would be needed to effectuate that vision would produce an enterprise quite different from a conventional government agency. As will be seen below, those changes include the repeal of the statutory monopolies; a restatement of the Postal Service’s mission to eliminate its current incentives to maximize volumes; a redefinition of universal service and shift to new means of funding universal service. Such changes would amount to more than improving the financial performance of the Postal Service in its current form.

Moreover, to implement that vision, we propose that postal reforms be based on two broad principles. The first principle is to define the Postal Service’s mission so as to *remedy conditions of market failure*. In a market economy, the scope of governmental intervention should indeed be limited to the correction of market imperfections.¹⁸ All other matters should be left to competitive interactions between private actors. As a consequence, in the postal sector, the role of the Postal Service should only encompass the provision of universal service. The second overarching principle is to *avoid competitive distortions* through the pricing and product offerings of the Postal Service. This goal entails avoiding government production in markets that are or can be served satisfactorily by private firms, as well as avoiding discrimination among mailers and among competitors in secondary markets. As will be seen below, evidence suggests that state-owned enterprises are more likely to engage in anticompetitive behavior than their private counterparts. Particular attention should thus be given to the prevention of discriminatory practices by the Postal Service.

The implementation of the proposed reform would require new legislation. The last major reform in the American postal sector is now more than thirty years old, and few students of the subject would dispute that legislative reform is now warranted. The new

17. See, e.g., SIDAK & SPULBER, PROTECTING COMPETITION FROM THE POSTAL MONOPOLY, *supra* note 12, at 152 (“Some influential constituencies no doubt believe that a privatized Postal Service would reduce their economic welfare.”).

18. See, e.g., *id.* at 58 (“the proper scope of market entry by a government-owned firm should be defined by the scope of the market failure that this form of government intervention seeks to redress”).

postal legislation should contain a small number of provisions that would provide for a set of basic principles of postal regulation.¹⁹ The implementation of such principles should be left to the Postal Rate Commission (PRC), the powers of which should be vastly extended.

From this vision flow specific recommendations for making the Postal Service a better public service government enterprise, which we will analyze in the following parts of this article. Those recommendations encompass the postal monopoly (Part II), market entry and exit (Part III), universal service (Part IV), costing (Part V), rate design and mail classification (Part VI), the revitalization of the PRC (Part VII), and the application of antitrust standards to the Postal Service (Part VIII).

Before turning to an analysis of these recommendations, it is helpful to keep in mind that the United States is not the only country that has engaged in postal reform. In fact, many other nations—particularly the Member States of the European Union—are far ahead of the United States in promoting competitive postal markets. Occasionally, our analysis will thus refer to the postal liberalization process taking place in the European Union under the impulsion of the European Commission.²⁰

Finally, we will compare the European and American perspectives on the application of antitrust law to state-owned postal operators. In doing so, our analysis will discuss the Supreme Court's 2004 decision in *United States Postal Service v. Flamingo Industries (USA) Ltd.*, which held that the Postal Service is immune from antitrust law.²¹ Lawyers and economists in the European Union will likely find *Flamingo Industries* anachronistic in light of the European Commission's vigorous application of competition law to Europe's government-owned postal operators. We argue that Congress should legislatively overrule *Flamingo Industries* by waiving sovereign immunity for the Postal Service with respect to its commercial activities outside any remaining statutory monopolies.

19. As illustrated by the Telecommunications Act of 1996, detailed legislation encourages rent-seeking. There can be little doubt that armies of lobbyists funded by telecommunications operators influence congressional debates over extremely complex and detailed provisions. See DAMIEN GERADIN & MICHEL KERF, *CONTROLLING MARKET POWER IN TELECOMMUNICATIONS: ANTITRUST VS. SECTOR-SPECIFIC REGULATION* (Oxford University Press 2003).

20. For a general analysis of such reforms, see *THE LIBERALIZATION OF POSTAL SERVICES IN THE EUROPEAN UNION* (Damien Geradin ed., Kluwer Law Int'l 2002).

21. 124 S. Ct. 1321 (2004).

II. The Postal Monopoly

The first fundamental reform that we propose relates to the postal monopolies enjoyed by the Postal Service over the delivery of letters (the Private Express Statutes) and over access to the customer's mailbox. Currently, the Postal Service is the only entity allowed to put "mailable matter" in customers' mailboxes.²² Moreover, the Postal Service defines by regulation the scope of its own letter monopoly. This peculiar arrangement appears to be unique in the regulation of monopoly in the United States and abroad. Plainly, the Postal Service has no incentive to construe its monopoly narrowly. For example, the Postal Service created an exception for "extremely urgent" mail only under the implicit threat that Congress otherwise would amend the statutory letter monopoly to permit firms such as Federal Express and United Parcel Service to deliver overnight mail.²³ This system of regulation-by-the-regulated is obviously unsatisfactory and needs to be overhauled.

The Postal Service's monopoly over mailbox access should be repealed, as it has three negative economic consequences.²⁴ First, it enables the Postal Service to raise the cost of its rivals' deliveries: Federal Express or United Parcel, for example, may not leave its overnight letter in the mailbox if the recipient is not home. The carrier will have to attempt another delivery, unless the sender designates that the urgent letter may be left at the door if the recipient is not there. A second and related consequence is to deter vertical integration into mail delivery by businesses (such as banks and utilities) with large numbers of routine mailings to virtually every postal customer on a given route. The third consequence of this monopoly is that it raises the cost to the customer of substituting alternative delivery services for those of the Postal Service because his reliance on the former will require him to construct a new receptacle for private express deliveries. The repeal of legal restrictions on access to mailboxes by competitors of the Postal Service would properly treat the customer's mailbox as the private property that it is. The deregulation of mailbox access would increase competition across various future and existing classes of mail by lowering costs for competitors of the Postal Service and lowering the customer's cost of switching from the Postal Service to a private express firm. Open access to the customer's mailbox would permit the development of innovative features, as has occurred with the deregulation of customer premises equipment in tele-

22. 18 U.S.C. § 1725. *See also* SIDAK & SPULBER, PROTECTING COMPETITION FROM THE POSTAL MONOPOLY, *supra* note 12, at 33-38.

23. *Id.* at 26-31.

24. *Id.* at 34-35.

communications. Eliminating that small but widespread entry barrier would facilitate competitive services and increase customer convenience.

In addition, the scope of the Postal Service monopoly over the delivery of letters should be substantially reduced. The Presidential Commission proposed that the postal monopoly be limited to mail falling within certain weight limits. Specifically, the Commission proposed that the postal monopoly include “[a]ny hard copy communication that is to be conveyed and delivered to a specific address in the United States indicated by the sender, provided its weight is less than 12 ounces and the delivery price is less than the basic stamp price times six.”²⁵ Under this approach, inspired by the postal reform undertaken in the European Union since 1997,²⁶ the Postal Service would have a monopoly over the delivery of all envelopes weighing less than 12 ounces unless the private carrier charged more than six times the price of a First-Class stamp. Although such a reduction of the Postal Service’s monopoly over letters would be progress, it remains more protective than the weight and price limits adopted in the European Union (set respectively at 350 grams or 12.5 ounces in 1997, reduced to 100 grams or 3.5 ounces and five times the stamp price in 1997, and reduced again to three times the stamp price in 2003). Moreover, the Presidential Commission fails to specify the percentage of the letter delivery market that would be open to competition further to adoption of the proposed limits. In fact, most of the mailed letters weigh considerably less than 12 ounces, and many customers prepared to pay at least six times the price of the stamp are already relying on expedited services, such as Federal Express or UPS. Consequently, the proposed market opening probably would have minimal effect. Before taking any decision on this issue, it is crucially important to know what percentage of the market would be affected.

III. Market Entry and Exit

Currently, the Postal Service appears to maximize output (number of pieces of mail) or some combination of output and other goals, all ostensibly in the furtherance of its USO. Because neither loss-minimization nor profit-maximization is required of the Postal Service, the enterprise has an incentive to engage in a continual “mission creep” into categories of mail (as well as non-mail products and services) that have less and less to do with “binding the nation together” through universal mail delivery. This economic prediction is consistent with anecdotal evidence that the management of the Postal Service

25. PRESIDENTIAL COMMISSION, *supra* note 4, at 23.

26. See Article 7 of Directive 97/67 on common rules for the development of the internal market of Community postal services and the improvement of the quality of service, 1998 O.J., L 15/14, awarded by Directive 2002/39 of 10 June 2002 amending Directive 97/67 with regard to the further opening to competition of Community postal services, 2002 O.J. L 176/21.

seems to focus on volume maximization. As one of us wrote in 1995: “The Postal Service no longer seeks to plug gaps in the provision of public services. Rather, it seeks to divert business from private firms in existing and emerging industries.”²⁷

A March 2003 report filed by the Postal Service at the PRC supports this assessment and concedes the inherent risk of the agency’s ventures into such non-postal services as pre-paid calling cards and electronic bill payment.²⁸ We question whether regulators should permit such ventures without strict conditions and monitoring. The Postal Service stated:

“Like any venture that depends on creating value and attracting revenue, the Postal Service needs the room to try new things, spread risk, stimulate innovation, and have flexible access to marketplace skills through partnerships. As with any new business initiative, it is reasonable to expect that some offerings will meet planned objectives while others will not. Undertaking new services requires a look forward and thus involves inherent risk.”²⁹

Previous ventures illustrate how risky the Postal Service’s entry into non-postal markets can be. In 1998, the General Accounting Office found that, from 1995 through 1997, the Postal Service lost more than \$84 million on its development and marketing of non-postal products.³⁰ In addition to prepaid telephone calling card and electronic commerce services, those money-losing non-postal products included a remittance service, REMITCO, which the Postal Service ultimately scrapped. However, regulatory concerns would remain even if those ventures generated profits. When unregulated or poorly regulated monopolies enter into competitive services, there is a significant risk of cross-subsidization.³¹

The PRC should have the authority to approve, disapprove, or impose conditions on the Postal Service’s entry into new markets. The proper analysis concerning product development and market entry should consist of two questions. The first question is, “Is there a market failure that requires a government-owned enterprise to produce a particular good?” If there is no market failure at all, or if there is a market failure that can be recti-

27. SIDAK & SPULBER, PROTECTING COMPETITION FROM THE POSTAL MONOPOLY, *supra* note 12, at 158-59.

28. See U.S. Postal Service, Report on Nonpostal Initiatives (filed Mar. 10, 2003, Postal Rate Comm’n).

29. *Id.* at 10.

30. GENERAL ACCOUNTING OFFICE, U.S. POSTAL SERVICE: DEVELOPMENT AND INVENTORY OF NEW PRODUCTS (GAO/GGD-99-15, Nov. 24 1998).

31. There is a vast literature on cross-subsidization. See, e.g., Gerald R. Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, 65 AM. ECON. REV. 966 (1975); Timothy J. Brennan, *Cross-Subsidization and Cost Misallocation by Regulated Monopolists*, 2 J. REG. ECON. 37 (1990).

fied by means other than the production of the particular good by a government-owned enterprise, then the Postal Service should not produce that good. If there is a market failure, the second question should be, “Will provision of the product by the Postal Service enhance its ability to deliver its core services?” The burden of proof should be on the Postal Service. The PRC should give public notice of the Postal Service’s application to enter a new market, and interested parties should be entitled to file comments and reply comments in support of, or in opposition to, the application.

A government enterprise like the Postal Service may enjoy privileges and immunities that would give it a competitive advantage over private firms in the production of many goods and services. But such privileges and immunities should be granted to advance only the inherently governmental functions of the enterprise, not its commercial functions. By way of comparison, Federal Prison Industries employs low-paid federal prisoners to make products that by statute must be purchased by agencies of the U.S. government. But the inherently governmental function of rehabilitating and training convicts at less than minimum wage would not justify Federal Prison Industries’ production of every good that could conceivably make a marginal contribution to the agency’s revenue adequacy. To the contrary, these privileges to undercut efficient competitors and allocate government procurement contracts exist to permit Federal Prison Industries to achieve its inherently governmental mission of rehabilitating and training federal prisoners. The Postal Service’s product developments and market entry should be judged with a similar view to whether this public service government agency is advancing its essential mandate.

The PRC also should have the power to compel the Postal Service’s exit from any market that is outside the core services covered by its USO. The PRC should issue an order to exit after an evidentiary proceeding. The PRC should be able to commence such a proceeding on its own motion or in response to a petition filed by an interested party. In a rulemaking, the PRC should establish the economic and other factors relevant to deciding whether the Postal Service must exit a market. In the same rulemaking, the PRC should allocate the burden of proof.

IV. Universal Service

Universal service exists as a policy because it is regarded as a public good that would be undersupplied by private firms.³² The Postal Service should have the responsibility to discharge a universal service obligation, but it should not be the governmental entity that

32. See, e.g., SIDAK & SPULBER, PROTECTING COMPETITION FROM THE POSTAL MONOPOLY, *supra* note 12, at 16-17.

defines the USO. Currently, however, the definition of the Postal Service's USO is vague and its cost is unknown.³³ This arrangement invites the possibility that the Postal Service will continually expand its interpretation of the USO to consume all free cash flow that the agency can generate.

The PRC should thus supply a precise definition of the USO. To avoid confusion, that definition should clearly specify the content of universal service in terms of services covered,³⁴ the quality of service expected, and the pricing principles to be relied upon.

Although pricing issues will be analyzed below, one key pricing issue relates to whether the Postal Service should remain compelled to maintain uniform rates. The implementation of uniform rates indeed requires cross-subsidization strategies (for example, between high-cost and low-cost areas), which are often used as an excuse to maintain a wide postal monopoly.³⁵ In addition to promoting allocative inefficiency, uniform rates would also be one of the factors preventing the development of competitive letter delivery services.

The definition of universal service should take into account the availability and affordability of other media of delivery and communications. The presence of alternative communications means could be interpreted as an absence of market failure and thus the lack of need for government-mandated provision of certain postal services. In addition, the PRC should have the power to revisit the definition of the USO in light of changes in technology, consumer demand, or other relevant factors. As one of us has written elsewhere, universal service is a dynamic concept, the content of which should be adapted on a regular basis.³⁶

The PRC should also require from the Postal Service an objective measure of the cost of the USO. There is a realistic possibility that the conventional wisdom about the costs of universal service is erroneous. For example, economists at the PRC have found empirical evidence that the cost of mail delivery in rural areas is virtually the same as in urban ar-

33. *See id.* at 154-56.

34. For instance, universal service could be limited to only the delivery of letters. More expansive definitions could include the delivery of parcels up to a certain weight or even the delivery of newspapers, magazines, and advertising mail. *See* PRESIDENTIAL COMMISSION, *supra* note 4, at ch. 2, 28.

35. *See* Peter Smith, *Subscribing to Monopoly, The Telecom Monopolist's Lexicon—Revisited*, PUBLIC POLICY FOR THE PRIVATE SECTOR, Note No. 53, at 3 (World Bank, Sept. 1995).

36. Damien Geradin, *The Opening of State Monopolies to Competition: Main Issues of the Liberalization Process*, in *THE LIBERALIZATION OF STATE MONOPOLIES IN THE EUROPEAN UNION* 181, 197 (Damien Geradin, ed., 1999).

eas, in part because of the clustering of mailboxes along rural highways.³⁷ An issue that should not be overlooked is the interface between the level of quality required for the universal service and the costs of such service. Obviously, an obligation placed on the universal service provider to offer a high-level of quality in terms, for instance, of number of weekly deliveries will drive up costs and trigger claims by the incumbent for the maintenance of a large postal monopoly. Massive direct mailings of advertisements or bills do not require six-day-a-week delivery on a ubiquitous basis. Put differently, suppose we take the definition of the USO to mean that, on any given day of the six-day delivery week, it is the policy of the U.S. government that a household should be able to receive a piece of direct mail or a bill, even if there are no other kinds of mail going to that household that day. Plainly, such a policy would imply a higher cost of universal delivery than if direct mail and bills were aggregated and delivered on a larger scale on a less frequent schedule than six days per week. This more episodic delivery schedule would reduce the cost of universal delivery, making it more likely that delivery to low-density areas could be competitively supplied. In other words, some or all of the market failure would go away.

This example illustrates an important point of great generality: The appearance of market failure that necessitates the provision of services by the Postal Service may be an artifact of some distortion caused by regulation. In economic jargon, the apparent need for government intervention in postal delivery is “endogenous”—it is affected by other policies or variables that the government has the power to control.³⁸ In this example, that other policy or variable is the frequency of delivery. By requiring more frequent delivery than consumers really want, given the likely composition of the mail stream to their homes, private firms are made to appear less able to satisfy the mail delivery needs at a lower cost.

37. See Robert H. Cohen, William W. Ferguson & Spyros S. Xenakis, *Rural Delivery and the Universal Service Obligation*, in REGULATION AND THE NATURE OF POSTAL AND DELIVERY SERVICES 161 (Michael A. Crew & Paul R. Kleindorfer, eds. 1993). A draft report by several of these same authors updates and confirms these results. See Robert H. Cohen, Matthew Robinson, John D. Waller & Spyros S. Xenakis, *The Cost of Universal Service in the U.S. and Its Impact on Competition* (Office of Rates, Analysis and Planning, Postal Rate Commission, Draft Mar. 25, 2003), available at <http://www.prc.gov/main.asp?Left=about.asp&Right=home.asp>. See also RICK GEDDES, *SAVING THE MAIL: HOW TO SOLVE THE PROBLEMS OF THE U.S. POSTAL SERVICE* 19 (AEI Press 2003).

38. See SIDAK & SPULBER, *PROTECTING COMPETITION FROM THE POSTAL MONOPOLY*, *supra* note 12, at 58-59; J. Gregory Sidak, *The Economics of Mail Delivery: Commentary*, in GOVERNING THE POSTAL SERVICE 14, 14-15 (J. Gregory Sidak ed., AEI Press 1994). The endogeneity of perceived market failure is a familiar feature of U.S. telecommunications regulations concerning network unbundling and spectrum allocation. See Jerry A. Hausman & J. Gregory Sidak, *A Consumer-Welfare Approach to the Mandatory Unbundling of Telecommunications Networks*, 109 YALE L.J. 417, 464-66 (1999).

There is also an interface between the quality of universal and the mechanisms used to control the prices of reserved services. In network industries subject to price-cap regulation, a regulated utility is expected to show improvements in productivity over time without any degradation in service quality.³⁹ Whether or not a price-cap regime is adopted for the Postal Service, the PRC should have the authority to set productivity and service-quality targets for the Postal Service. The expectation should be that both productivity and service quality will rise over time.

The definition of universal service also should address the availability of retail and collection functions that are currently supplied by post offices. Some of those functions could be, and already are, supplied by private firms—such as the sale of postage over the Internet by Pitney Bowes, the leasing of private delivery boxes in retail outlets such as Mailboxes Etc., the placement of post offices in existing retail establishments such as Wal-Mart stores, and the collection of outgoing letters and parcels. It is not clear that all of those retail services would need to be provided on a universal basis in a given region by the same entity that provides universal *delivery* services.

Disaggregating the definition of the USO by core delivery functions and core retail and collection functions would help to identify the specific components of universal service that are subject to market failure. In fact, it seems that most operational phases of the postal service could be achieved on a competitive basis.⁴⁰ The total cost of universal service might thus be found to be smaller than previously believed, and the funding of universal service could be more productively targeted to the specific activities that truly are subject to market failure.

The PRC also should have the authority to close post offices. At a minimum, the PRC should be authorized to approve or reject the Postal Service's proposed closures and to order such approvals to take effect. This power should not be subject either to lengthy judicial review or to congressional micromanagement through appropriations riders or other means.

39. One problem with price-cap regulation is that it provides lower incentives to maintain quality because the firm might benefit from cost reductions that would jeopardize quality. This risk is higher in industries, such as postal services, where quality is difficult to observe or where customers do not have a choice of suppliers, so that lower quality does not necessarily induce lower sales. It is not clear that the Postal Service would compromise quality were it submitted to price caps, as it is not a profit maximizer. However, as we will discuss in Part VI below, other problems suggest that price caps might be poorly tailored to the regulation of the Postal Service's rates.

40. See SIDAK & SPULBER, PROTECTING COMPETITION FROM THE POSTAL MONOPOLY, *supra* note 12, at 39-60.

In short, the USO should be thoroughly reevaluated, taking into account electronic substitution, among other market factors. It cannot be expected, however, that Congress would enact legislation giving sufficient detail to make a new USO definition operational. A rulemaking before the PRC would be the appropriate vehicle for assembling a public record

V. Costs

The accurate measurement of costs is critical to the proper operation of the Postal Service as a public service government agency. Along with demand estimates, cost data are the principal inputs in the rate-setting process. Accurate cost data are also necessary to evaluate the burden of providing universal service. Currently, the Postal Service has too much control over how it calculates and reports its costs.

The revenue requirement is the starting point for any rate case. Currently, however, the Postal Service sets its own revenue requirement,⁴¹ something that no state public utility commission would permit any telephone company or electric utility to do. As for the definition of universal service, there is a clear conflict of interests as there is little doubt that the Postal Service will always be tempted to exaggerate its revenue requirement. This higher revenue requirement will in turn be used by the Postal Service as an excuse to justify entry into more competitive services at the expense of competitive postal providers and consumer welfare.

The PRC should thus be able to reject the Postal Service's proposed revenue requirement and order an alternative revenue requirement of its own determination. For this and other ratemaking purposes, the PRC must have the power to subpoena the Postal Service to produce cost information and other relevant data. These reforms would simplify and expedite rate cases before the PRC: If the PRC had subpoena power to force the Postal Service to supply accurate and complete cost data, then the Postal Service, knowing that the PRC had that power, would supply better data from the outset of a rate case.

The PRC should establish, outside a rate case, the general methodology for calculating attributable costs and institutional costs, and for allocating institutional costs to classes of mail. Rulemakings to determine this kind of methodological question are commonplace at state and federal regulatory commissions. This issue has received considerable attention in the course of postal reforms undertaken in foreign jurisdictions.

41. *Id.* at 91.

For instance, EU Postal Directive 97/67, as amended by Directive 2002/39, provides that universal service providers must keep separate accounts within their internal accounting systems at least for each of the services within the monopoly sector on the one hand and for competitive services on the other hand.⁴² The directive also provides that these accounting systems should allocate costs to each of the reserved and nonreserved services on the basis of the allocation method prescribed in the directive. That allocation method requires all costs incurred by universal service providers to be fully allocated between reserved services and nonreserved services. This rule implies not only an allocation of the costs that can be directly assigned to a particular service, but also an allocation of the costs that are common to reserved and nonreserved services. The directive provides, however, that other cost accounting systems may be applied, provided they are compatible with the accounting separation requirement and have been approved by the national regulatory authority.⁴³ In addition, the postal regulators of the Member States should ensure compliance with those different accounting procedures,⁴⁴ as well as keep available information on the cost accounting system applied by a universal service provider.⁴⁵

Another cost-related issue that could become of central importance in the postal sector relates to the price of inputs sold by the Postal Service to its competitors. By way of comparison, the most controversial and time-consuming question that the Federal Communications Commission (FCC) has faced since passage of the Telecommunications Act of 1996 has been the determination of the proper cost-based *methodology* to use to price competitor access to the local network.⁴⁶ The FCC has addressed this methodological question in multiple rulemakings, even though state commissions are ultimately responsible for setting actual rates. The PRC should similarly establish general rules on costing methodology that the Postal Service and other parties must follow in all subsequent rate cases. This issue will be further addressed in Part VI below.

Regardless of the methods used to calculate the revenue requirement and categories of costs, the Postal Service needs the operational flexibility to cut large categories of costs. As implied by the earlier analysis of universal service, the Postal Service would have greater flexibility to reduce the cost of operating uneconomic post offices if the PRC had the authority to close them without congressional interference. More generally, the PRC

42. See Art. 14(2) of the Directive.

43. *Id.*, Art. 14(3).

44. *Id.*, Art. 14(5).

45. *Id.*, Art. 14(6).

46. See, e.g., J. GREGORY SIDAK & DANIEL F. SPULBER, DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT: THE COMPETITIVE TRANSFORMATION OF NETWORK INDUSTRIES IN THE UNITED STATES 307-92 (Cambridge University Press 1998); Hausman & Sidak, *supra* note 38.

should be empowered to disallow the recovery through rates of any cost item—including labor costs and capital expenditures—that it determines to be excessive, imprudently incurred, or otherwise unjustified. This kind of regulatory power is commonplace among state public utilities commissions.

The methodology used to control the prices of reserved services could also be designed to provide the Postal Service with incentives to cut costs. The most frequent method used by regulators of network industries to provide such incentives is to place a cap on the prices that the firm may charge.⁴⁷ Price caps are usually imposed upon baskets of prices—a weighted average of those prices cannot exceed the cap. The pricing formula generally enables the regulated firm to pass on to users cost increases outside of its control (such as inflation or other exogenous costs). Price-cap regulation also reflects the scope for productivity gains that the firm is able to achieve.

Currently, the Postal Service is not subject to any explicit price-cap regulation, and its rate proceedings occur relatively quickly. Indeed, the statutory requirement that the Postal Rate Commission issue recommended decisions, although desirable on grounds of administrative efficiency, incidentally contributes to the inability of postal rates to resemble price caps. Rate proceedings could, however, be modified to accommodate a price-cap regime and, in its recommendations, the Presidential Commission proposes the deployment of “rate ceilings” inspired on the price-cap model.⁴⁸

Yet, it is not clear that price caps could work for the Postal Service.⁴⁹ As we have seen above, the Postal Service does not have as its mission to maximize profit. Consequently, the driving force that produces consumer benefits when price caps are applied to a privately owned firm—the firm’s incentives to minimize costs and thereby increase profits—would be absent if price caps were applied to the Postal Service. Even if there were no requirement that the Postal Service operate on a break-even basis, both experience and economic theory strongly suggest that the management of this public enterprise does not attempt to maximize profit or minimize cost. If so, then the Postal Service would not respond to the incentives that price caps present.

47. See MARK ARMSTRONG, SIMON COWAN & JOHN VICKERS, *REGULATORY REFORM: ECONOMIC ANALYSIS AND BRITISH EXPERIENCE* 165 (MIT Press 1994).

48. See PRESIDENTIAL COMMISSION, *supra* note 4, at 58. Some academics have also proposed to subject the Postal Service to price caps. See Michael Crew & Paul Kleindorfer, *Pricing, Entry, Service Quality, and Innovations under a Commercialized Postal Service*, in *GOVERNING THE POSTAL SERVICE* 150, 161-67 (J. Gregory Sidak ed., AEI Press 1994).

49. See SIDAK AND SPULBER, *PROTECTING COMPETITION FROM THE POSTAL MONOPOLY*, *supra* note 12, at 105.

VI. Rate Design and Mail Classification

Rate design and mail classification can be improved by both procedural and substantive reforms. These reforms would change significantly the nature of the relationship between the Postal Service and the PRC.

A. *Increase the Power of the Postal Rate Commission*

The PRC should have greater powers over rate design and mail classification. It should streamline rate cases by deciding costing methodologies and mail classifications in separate proceedings. The PRC also should have the power to impose binding rates that the Postal Service cannot veto. The current veto power of the Board of Governors is unprecedented among regulatory agencies.⁵⁰ In addition, the PRC should have the final authority to establish mail classifications.

B. *Do Not Fund the USO with Monopoly Rents*

The Postal Service should not fund its USO with monopoly rents from any class of mail subject to the Private Express Statutes. From a consumer welfare perspective, it would be regrettable if the nation's commitment to providing mail service to rural and other high-cost segments of the population were to deny *all* consumers of monopoly mail services the substantial benefits of having First-Class mail service at the price that would be charged in a competitive market.⁵¹ The traditional purpose of a statutory monopoly is to prevent cream skimming of high-margin customers by competitors who bear no USO.⁵² A statutory monopoly should not exist to charge a monopoly price to all customers of a core service.

There is no clear correspondence between the USO revenue deficiency and the monopoly rents generated for the Postal Service by the statutory monopoly over the delivery of

⁵⁰ See *id.* at 160.

⁵¹ There is also a jurisprudential argument against funding universal service or other incumbent burdens through the creation of artificial monopolies. The cross-subsidies in postal rates are an implicit regime of taxes and appropriations. Taxing and spending is properly the role of Congress under Article I of the Constitution. U.S. CONST. art. I, § 8, cl. 1; *id.* § 9, cl. 7. Congress should not delegate those decisions to the Postal Rate Commission and the Postal Service—neither of which has any direct political accountability to the electorate. The magnitude of the subsidy to rural recipients of mail should be apparent from an explicit line item in the budget; it should not be an amount that can be inferred only by undertaking extensive economic analysis of the cross-subsidies that the monopoly over letter mail makes possible.

⁵² See Smith, *supra* note 35.

letters. Funding the USO through monopoly rents sacrifices consumer welfare in classes of mail that provide the subsidy. Monopoly mail should make a reasonable contribution to the recovery of the Postal Service's institutional costs, but consumers should not be forced to pay monopoly prices for such mail.

There are at least two general means by which Congress could decouple universal service from the Private Express Statutes. First, Congress could send postal subsidies directly to consumers in rural areas. Those subsidies could even be means-tested, if one's low income were considered to be more important than one's rural address. Those customers would then be billed directly by the carrier of last resort for the high cost of what might be called "terminating access," to borrow a telecommunications concept. The lower basic stamp price that would result for all mailers would not include the surcharge for delivery to costly, remote areas.

A second means of financing universal service would be for the government to use a series of negative auctions. Any financially sound firm (including foreign posts) should be permitted to bid in auctions to provide universal service to sensibly defined regions of the country. Under such an auction, the carrier asking for the lowest government subsidy (which might even be zero) would win the concession to deliver mail to a designated region for a designated term of years, subject to clearly defined performance standards, such as frequency of delivery. This system has succeeded in the telecommunications field. For example, in Chile it has led to drastic reductions of the cost of universal service.⁵³

These two funding mechanisms could be used separately or in combination. If Congress were to adopt them, it could end the false rhetoric that American consumers must tolerate a monopoly to have universal service. In addition, it would create a USO funding mechanism that would be competitively neutral across the Postal Service and its rivals.

C. Rate Discounts Should Be Available to All Mailers and Be Based on Avoided Costs, Not Negotiating or Lobbying Skill

In keeping with the goal of charging nondiscriminatory rates, the Postal Service should not offer negotiated service agreements (NSAs) or "contracts" to single mailers. Such agreements are simply means of engaging in price discrimination for the benefit of favored mailers; they are not in keeping with a government-provided public service.

A government public service should not engage in negotiating rates with selected mailers. First, the concept of an NSA—that the USPS would negotiate the rate with a se-

53. For an analysis of the Chilean experiment, see GERADIN & KERF, *supra* note 19, at 246-48.

lected mailer—is inconsistent with the principle that the PRC should have the final say in setting rates.

Second, rates for a government-provided postal service should be based on the costs of providing the service, not on the negotiating skill or gamesmanship of the particular mailer. NSAs conflict with the fundamental objective of the Postal Reorganization Act, which was to “get politics out of the Post Office” and instead base rates on costs, not lobbying skill.⁵⁴ It is easy to conceive of one mailer receiving a better rate than a similarly situated second mailer, due solely to the former’s negotiating prowess or influence. As John Panzar has shown in testimony before the PRC, there is no assurance that all classes of customers will benefit when a non-profit-maximizing firm such as the Postal Service engages in price discrimination.⁵⁵ In other words, price discrimination by a non-profit-maximizing firm does not ensure a Pareto improvement in consumer welfare. The Postal Service recently testified before the PRC that it currently lacks the infrastructure to handle more than a small number of NSAs, meaning that the likelihood of discrimination is great.⁵⁶

Likewise, volume discounts unrelated to costs should not be allowed. A volume discount not based on costs would, by definition, treat larger mailers more favorably than smaller mailers. It would also tend to favor national mailers over local businesses, which may have smaller mail needs.

Furthermore, any private regulated firm negotiating a single-customer service contract would have a thorough, detailed understanding of the costs of serving that customer and of the savings or additional revenues that it would hope to gain. The Postal Service, however, is not organized to make those calculations. The Postal Service has no way to measure the costs that it actually incurs in serving a particular mailer. This result occurs because the Postal Service’s costing systems are based on estimates and extrapolations of large numbers on a class or subclass basis. These estimates and extrapolations are virtually worthless in determining the costs incurred by the Postal Service in handling any particular mailer’s mail. As a result, the Postal Service appears to be institutionally inca-

54. See, e.g., SIDAK & SPULBER, PROTECTING COMPETITION FROM THE POSTAL MONOPOLY, *supra* note 12, at 84 (“Congress intended postal reorganization to make the Post Office more businesslike and to insulate it from political influence.”).

55. Testimony of John C. Panzar on behalf of the Postal Rate Commission, Experimental Rate and Service Changes to Implement Negotiated Service Agreement with Capital One Services, Inc., Dkt. No. MC2002-2 (Postal Rate Comm’n filed Jan. 16, 2003).

56. Postal Rate Commission, Dkt. No. MC2002-2, Transcript Vol. 10, p. 1938 (Mar. 6, 2003, Cross-examination of USPS witness Michael K. Plunkett).

pable of making the kind of detailed, *a priori* cost analysis that any regulated private firm routinely performs before engaging in any negotiated contract.

Postal management may argue that NSAs provide incentives to mailers, such as through volume discounts, to mail more volume. This rationale has no merit for a public service government agency. The Postal Service does not have accurate information about either its own costs or the mailer's demand function and business plans. There is no reason to think that an NSA would not affect other private firms that compete with the favored mailer or that an NSA would somehow remedy a condition of market failure and not distort competitive markets.

For example, if the Postal Service were, through an NSA, selectively to reduce its rates for subclass *X*, it would artificially stimulate demand for greater mail output. That increased volume would have consequences beyond the superficial analysis of the unit revenue and unit cost of that volume alone. For example, it is possible that, for some types of mail, a volume increase could also increase the costs of providing universal service because of the increased need to make delivery to all points. Unless the Postal Service's costing is completely reliable, that stimulation of demand could cause the cost of universal service to be overstated.

The possible overstatement of the cost of universal service would be particularly problematic if there were no market failure to be remedied by such discriminatory stimulation of mail volume. For example, there is no market failure in the supply of advertising: newspapers, magazines, television (over the air, cable, and direct broadcast satellite), radio, Internet websites and advertisements, billboards, and telemarketing are all substitutes for direct mail as a means of informing consumers about products and services that are offered for sale. Consequently, there is no reason to stimulate the demand for advertising mail. To the contrary, such pricing would distort competition in the advertising market between direct mailers and other carriers of advertising. If, because it lacked reliable cost data, the Postal Service priced direct mail below its true long-run average incremental cost (LRAIC), then firms purchasing advertising would be encouraged to use a service that they valued less than the resources required to produce it. Meanwhile, sales of advertising would shift away from competitively supplied substitutes, which would have to cover their costs and earn a competitive return, lest the private firms producing them discontinue them.

In contrast, the Postal Service should continue to provide its services on an unbundled basis. Work-sharing is indeed an efficient way to introduce competition in postal services and to reduce the cost of mailing. In its comments before the Presidential Commission, the Direct Marketing Association argued that the existing model for establishing

for work-shared mail, which is based on avoided costs, should be replaced by a method calculating rates on the basis of the cost of the services or functions purchased by the mailer.⁵⁷ Reliance on such an approach, however, generates implementation difficulties and may not be appropriate for the Postal Service. For instance, experience in the telecommunications sector shows that the LRAIC methodology often amounts to subsidizing entry of competitors and thus encourages inefficient entry. Moreover, determining the forward-looking costs of a network is a difficult exercise (as it requires much information), which the Postal Service may not necessarily be able to provide. In the current situation, we thus recommend maintaining the current avoided-cost methodology for calculating rates for work-shared mail.

D. Eliminate the Content Restriction Across Classes of Mail

Apparently for historical reasons, the Postal Service has long engaged in price discrimination based on the content of the mail. In particular, postal regulations require most forms of personal and personalized correspondence to be mailed at First-Class. For example, current postal regulations require, as a general matter, the following types of mail to pay First-Class rates:

- mail sealed against inspection
- mail containing handwriting
- actual and personal correspondence
- bills and statements of account

These categories include a vast amount of mail, not all of which necessarily must arrive at its destination within the times set forth in the service standards for First-Class mail.

Content should not be the basis upon which rates are set for letter mail. Letter mail classifications should reflect only quality and cost characteristics, such as the speed of delivery, the costs of handling different shapes, and the degree of privacy. There is no reason to believe that the current classifications of mail are the same ones that would be offered by a competitive postal marketplace. It is noteworthy that neither FedEx nor UPS prices its overnight letter products on the basis of content.

By requiring all “personalized” correspondence to be mailed at First-Class rates, the current content restriction harms the public interest in several ways. First, it raises costs to

57. Comments of the Direct Marketing Association before the Presidential Commission on the United States Postal Service, Feb. 12, 2003, available at <http://the-dma.org/postal/postalcomments20030212.shtml>

mailers, by forcing them to pay higher First-Class rates when they might be willing to pay lower rates for a lower delivery speed or quality of service. This effect also artificially increases the Postal Service's costs by obligating it to provide faster, more costly First-Class service when a less costly, slower service would better suit the needs of certain mailers.

Second, the content restriction denies mailers choice. By forcing mailers into the "one-size-fits-all" of First-Class Mail, the Postal Service prevents mailers from having the opportunity to trade a lower cost for a slower speed service. The only real option available is the First-Class postcard rate, but that alternative suffers from serious size and privacy limitations. It is certainly plausible, for example, that an elimination of the content restriction in the current rate structure would induce greater product differentiation based on speed and quality of service. Currently, there is a substantial jump in price from First-Class mail to priority mail, but there is not a substantial improvement in product quality.

Third, the content restriction may force captive First-Class mailers to pay monopoly rates. For example, the markup (contribution per piece to overhead) for First-Class mail far exceeds that of Standard mail. Today, the PRC estimates that the average First-Class letter contributes 18.4 cents to institutional (overhead) costs, whereas the second-largest letter class—Standard Mail—contributes only about 8.1 cents.⁵⁸ That contribution amounts to a surcharge or tax of more than 10 cents per letter stemming directly from the content restriction.

As stated earlier, there is no reason to believe that a freely competitive market for letter mail would establish a content restriction or would price services on the basis of content. More likely, a competitive letter market would price on the basis of factors such as speed of delivery, shape (where, say, flat-sized pieces cost more to process, transport, or deliver than letter-shaped pieces), and service quality and reliability. It is likely that the service offering the faster, more secure delivery would have both higher costs and a pricing premium. Mailers would be free to choose whether they wanted to pay for that extra service.

Eliminating the content restriction in letter mail would reduce a substantial hidden tax, promote mailer choice, and help to realign the pricing structure for mail according to the service being delivered. Today, letter mail constitutes over 90 percent of the mail stream,

58. Postal Rate Commission, Opinion and Recommended Decision, Dkt. No. R2001-1, App. G, Schedule 1 (projections for fiscal year 2003).

which means that this reform would lead to the more efficient pricing of the vast majority of the mail.⁵⁹

VII. A Stronger Postal Rate Commission

One of our main recommendations is to strengthen the PRC's powers. The Presidential Commission shares this vision, as it proposed that the PRC be transformed into a new Postal Regulatory Board "with broad authority to set the public policy parameters within which the Postal Service is allowed to operate."⁶⁰ This authority would:

- Ensure the financial transparency of the Postal Service;
- Establish rate ceilings for Postal Service reserved products;
- Ensure that the Postal Service remains focused on traditional products and services;
- Ensure that competitive products are not cross-subsidized by revenues from reserved products;
- Guarantee that the Postal Service is meeting its universal service obligation and refine, as necessary, the specific elements of that obligation;
- Review proposed changes to service standards when such changes are expected to have a substantial and negative national impact;
- Review the postal monopoly for its public benefit and, if circumstances warrant, narrow it over time;
- Review work-sharing discounts, negotiated service agreements, and rates for reserved products for undue or unreasonable discrimination;
- Ensure that the Postal Service upholds its statutory obligation to compensate its employees at a level comparable to the private sector.

Although we do not necessarily share the view of the Commission as to the precise missions that should be entrusted to the postal regulator, we concur that this regulator should have much broader powers than under the current system.

As to the institutional structure of the postal regulator, we find the proposal of the Presidential Commission to transform the PRC into a Postal Regulatory Board interesting,

59. For reasons related to content, Congress does direct that certain types of mail—most notably, non-profit and periodicals—receive lower rates. Those preferential rates rest on additional social policies that are outside the scope of this article.

60. See PRESIDENTIAL COMMISSION, *supra* note 4, at 53.

although the proposed institutional changes it would imply appear fairly limited.⁶¹ A more provocative approach would be to merge the PRC and the Federal Communications Commission (FCC), because both are concerned with “binding the nation together” with communications and universal service. The FCC has expertise, resources, and political heft.⁶² It more often expands rather than surrenders its jurisdiction and regulatory prerogatives. It regularly litigates in the D.C. Circuit and Supreme Court against private companies as large or larger than the Postal Service in terms of assets and revenues. The FCC’s experience regulating AT&T, and later the Bell companies, as dominant carriers prepares it as an institution to be a stern regulator of the Postal Service in markets in which it is dominant. Combined regulators for telecommunications and postal services exist in Belgium, Germany, the Netherlands, and other countries. American policy makers could learn much from the experience of countries having a combined regulator.

Merging the PRC and FCC would also lend greater coherence to the understanding of universal service: The electronic alternative to physical delivery of mail would be explicitly considered in defining what the Postal Service’s mission should be. The migration from physical to electronic mail also would be more rigorously evaluated by an agency that already has regulatory jurisdiction over many matters concerning the Internet. If we are wiring schools and libraries to the Internet as a matter of universal service policy, should not that policy be explicitly considered when deciding how frequently mail should be delivered to remote areas? Should it not also have some bearing on whether it is necessary to provide ubiquitous delivery of certain kinds of mail (direct mail, bills) six days a week?

VIII. The Divergent Roles of Antitrust Law in the European Union and the United States after *Flamingo Industries*

In many foreign jurisdictions, competition authorities have used antitrust law to challenge anticompetitive conduct of state-owned postal operators. For instance, in 2001 the European Commission fined Deutsche Post € 24 million for abuse of its dominant position through predatory pricing and other practices.⁶³ This decision is one of a line of lawsuits undertaken by the Commission to prevent state-owned postal operators from engaging in anticompetitive behavior.

61. *Id.* at 56.

62. See GERADIN & KERF, *supra* note 19, at 78-81.

63 Case COMP/35.141, Deutsche Post AG, 2001 O.J. (L 125) 27. For an analysis of the decision, see David E.M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 ANTITRUST L.J. 479, 485 (2003).

In contrast, in the United States the Supreme Court held in February 2004 in *United States Postal Service v. Flamingo Industries (USA) Ltd.* that sovereign immunity shields the Postal Service from antitrust liability.⁶⁴ Flamingo, an Illinois producer of “circular-weave” mail sacks, sued the Postal Service after its contract was terminated and the Postal Service began purchasing “flat-weave” mail sacks from a Mexican firm. Flamingo argued that its circular-weave sacks were superior and that, by switching to the more labor-intensive flat-weave method of production, the Postal Service attempted to suppress competition and create a monopoly in mail sack production in violation of the Sherman Act.

The precise legal questions presented in *Flamingo Industries* were (1) whether section 401 of the Postal Reorganization Act (PRA)—which grants the Postal Service the power “to sue and be sued in its official name”⁶⁵—constituted a self-executing waiver of sovereign immunity with respect to antitrust law and (2) whether the Postal Service is a “person,” separate from the U.S. government, for purposes of being sued under federal antitrust law.⁶⁶ The case went to the Supreme Court from the U.S. Court of Appeals for the Ninth Circuit, which had held that “the Postal Service can be sued under federal antitrust laws because Congress has stripped the Postal Service of its sovereign status by launching it into the commercial world as a sue-and-be-sued entity akin to a private corporation.”⁶⁷ The Ninth Circuit found the Postal Service to be a “person” subject to liability under the Sherman Act because Congress had removed the agency’s immunity through enactment of section 401 of the PRA.⁶⁸ The Ninth Circuit reasoned that the Postal Service should be characterized as a federally chartered corporation, rather than as part of the U.S. government.⁶⁹ The Ninth Circuit’s outcome is consistent with the European perspective that competition law should apply with full force to state-owned postal operators.

The Supreme Court disagreed. In an opinion written by Justice Kennedy, the Court unanimously reversed the Ninth Circuit on both legal questions and held that “the Postal

64. 124 S. Ct. 1321 (2004).

65. 39 U.S.C. § 401.

66. “We ask first whether there is a waiver of sovereign immunity for actions against the Postal Service. If there is, we ask the second question, which is whether the substantive prohibitions of the Sherman Act apply to an independent establishment of the Executive Branch of the United States.” *Flamingo Industries*, 124 S. Ct. at 1327.

67. *Flamingo Indus. (USA) Ltd. v. U.S. Postal Serv.*, 302 F.3d 985, 988-89 (9th Cir. 2002).

68. *Id.* at 991.

69. *Id.* at 992.

Service is not subject to antitrust liability.”⁷⁰ The Court found that the waiver of immunity provided by section 401 of the PRA does not suffice to subject the Postal Service to federal antitrust law.⁷¹ Rather, the Court noted, Congress had not stripped the Postal Service of governmental status and had declined the opportunity to make the Postal Service a government corporation.⁷² Additionally, the Court found that the Postal Service, included as part of the U.S. government, is not a “person” that can be exposed to liability as an antitrust defendant, notwithstanding the fact that the U.S. government is authorized by statute to be an antitrust plaintiff.⁷³ “In both form and function,” wrote Justice Kennedy, the Postal Service “is not a separate antitrust person from the United States but is part of the Government, and so is not controlled by the antitrust laws.”⁷⁴ It appears from the Court’s reasoning that either legal conclusion would suffice to shield the Postal Service from application of the antitrust laws.

It is not the purpose of this article to express an opinion on whether the Court was correct in its analysis of sovereign immunity doctrine and in its interpretation of the meaning of a defendant “person” under the Sherman Act. But even if one accepts without question that the Court provided correct doctrinal answers to these two questions of interpretation, it certainly could not have done so by relying on the incorrect economic reasoning and factual propositions advanced in Justice Kennedy’s opinion for the Court. These incorrect statements are all dicta in the strict sense of judicial interpretation. None is essential to the Court’s outcome on either legal question. As a matter of competition policy, however, Justice Kennedy’s unnecessary economic assertions are not harmless error. Incorrect reasoning by the Court is likely to be quoted back in future proceedings and may influence regulatory decisions in a manner detrimental to consumer welfare.

Justice Kennedy implied that the Postal Service has less ability than a private firm to act anticompetitively: “in ways . . . relevant to the nonapplicability of the antitrust laws to the Postal Service, its powers are more limited than those of private businesses.”⁷⁵ Without citing any supporting authority from economic theory, regulatory law, or antitrust law, Justice Kennedy wrote that the Postal Service “lacks the prototypical means of engaging in anti-competitive behavior: the power to set prices.”⁷⁶ He supported this proposition with a stylized description of postal ratemaking and a non sequitur that

70. U.S. Postal Serv. v. Flamingo Indus. (USA) Ltd., 124 S. Ct. 1321, 1323 (2004).

71. *Id.* at 1327.

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.* at 1328.

76. *Id.* at 1329.

speaks to the Postal Service’s incentive, rather than its ability, to engage in anticompetitive behavior: “This is true both as a matter of mechanics, because pricing decisions are made *with the participation* of the separate Postal Rate Commission, and as a matter of substance, because price decisions are governed by principles other than profitability.”⁷⁷ It is disingenuous to suggest that the PRC’s “participation” in ratemaking results in a binding price constraint being imposed on the Postal Service. The PRC sets recommended rates, which the Board of Governors of the Postal Service is free to reject.⁷⁸ Early in his opinion, Justice Kennedy discussed this aspect of postal regulation, noting that the PRC “*advises* the Board of Governors on rates for all postal services,” but that rates ultimately “are set by the Board of Governors based on the *recommendations* of the Commission.”⁷⁹ Remarkably, Justice Kennedy evidently did not recognize that the non-binding nature of PRC ratemaking demolishes his reasoning that the Postal Service poses no threat of anticompetitive behavior because it lacks the ability to set prices.

Contrary to Justice Kennedy’s depiction of competition in postal markets, the Postal Service enjoys far greater discretion over pricing in reserved markets than any privately owned telephone company or electric utility subject to rate or price regulation administered by a state public utility commission. In essence, Justice Kennedy was arguing that, relative to a private business, the Postal Service lacks the *opportunity* to charge supra-competitive prices. Certainly with respect to its reserved markets—those protected by statutory monopolies—the Postal Service has the ability to charge excessive prices, even ones exceeding stand-alone cost.

With respect to its (low) pricing in nonreserved markets—where private firms compete—the Postal Service is currently not subject to any requirement other than the statutory mandate that each service cover its incremental cost and make at least some token

⁷⁷ *Id.* (emphasis added).

⁷⁸ 39 U.S.C. §§ 3622, 3601, 3625(d). *See* Time, Inc. v. U.S. Postal Serv., 710 F.2d 34 (2d Cir. 1983); Time, Inc. v. U.S. Postal Serv., 685 F.2d 760 (2d Cir. 1982). Section 3625(d) provides: “The Governors may reject the recommended decision of the Commission and the Postal Service may resubmit its request to the Commission for reconsideration. Upon resubmission, the request shall be reconsidered, and a further recommended decision of the Commission shall be acted upon under this section and subject to review in accordance with section 3628 of this title. However, with the unanimous written concurrence of all of the Governors then holding office, the Governors may modify any such further recommended decision of the Commission under this subsection if the Governors expressly find that (1) such modification is in accord with the record and the policies of this chapter, and (2) the rates recommended by the Commission are not adequate to provide sufficient total revenues so that total estimated income and appropriations will equal as nearly as practicable estimated total costs”; 39 U.S.C. § 3625(d).

⁷⁹ *Flamingo Industries*, 124 S. Ct. at 1325 (citing 39 U.S.C. §§ 3622, 3601, 3625) (emphasis added).

contribution to the recovery of common (institutional) costs.⁸⁰ Had Justice Kennedy considered the relevance of the European experience with applying competition law to state-owned postal operators, he would have recognized that the finding of liability in *Deutsche Post* casts doubt on the accuracy of the Court's assumption that a state-owned enterprise like the U.S. Postal Service lacks "the prototypical means" to act anticompetitively. Instead, Justice Kennedy took a benign view of the Postal Service's activities in nonreserved markets: "The Postal Service does operate nonpostal lines of business, for which it is free to set prices independent of the Commission, and in which it may seek profits to offset losses in the postal business."⁸¹ The fact that the Postal Service undertakes "lines of business beyond the scope of its mail monopoly and universal service obligation," wrote Justice Kennedy, "do not show it is separate from the Government under the antitrust laws."⁸² He did not recognize that such expansion into nonreserved markets is also consistent with revenue (rather than profit) maximization, which increases the incentive of a public enterprise to engage in anticompetitive behavior.⁸³

Justice Kennedy was also incorrect to the extent that he suggested that the Postal Service has less of an *incentive* than a private firm to engage in anticompetitive behavior:

"The United States Postal Service has different goals, obligations, and powers from private corporations. Its goals are not those of private enterprise. The most important difference is that it does not seek profits, but only to break even, which is consistent with its public character."⁸⁴

Justice Kennedy presumed that the absence of a profit motive makes the Postal Service a more docile competitor in nonreserved markets. To the contrary, academic research that shows that, though they may be less concerned with generating profits, state-owned enterprises have stronger incentives than profit-maximizing firms to undertake anticompetitive behavior directed at competitors. Policy makers around the world have taken note of this analysis. The Organization for Economic Cooperation and Development

80 39 U.S.C. § 3622(b)(3).

81. *Flamingo Industries*, 124 S. Ct. at 1329 (citing 39 U.S.C. § 3403(a)).

82. *Id.*

83. See David E. M. Sappington & J. Gregory Sidak, *Incentives for Anticompetitive Behavior by Public Enterprises*, 12 REV. INDUS. ORG. 183 (2003); Sappington & Sidak, *Competition Law for State-Owned Enterprises*, *supra* note 63, at 480; David E. M. Sappington & J. Gregory Sidak, *Are Public Enterprises the Only Credible Predators?*, 67 U. CHI. L. REV. 271 (2000).

84. *Flamingo Industries*, 124 S. Ct. at 1321 (citing 39 U.S.C. § 3621).

(OECD) has recognized that public enterprises, including postal operators, pose a greater threat of anticompetitive behavior than do private firms producing the same services.⁸⁵

As one of us has argued elsewhere, the higher risk of anticompetitive behavior by state-owned companies justifies the adoption of a more demanding legal standard for scrutinizing their behavior than would apply to their private counterparts.⁸⁶ For example, this analysis indicates that, in predatory pricing cases, higher price floors should apply in nonreserved markets for state-owned companies that enjoy a statutory monopoly in a reserved market than would apply to a profit-maximizing firm serving the same nonreserved market.

Congress should legislatively overrule *Flamingo Industries*. In light of the Court's two rulings in *Flamingo Industries*, it is necessary for such legislation to establish unambiguously that (1) Congress has waived sovereign immunity for the Postal Service with respect to alleged antitrust violations committed in nonreserved markets, and (2) that the Postal Service is a "person" distinct from the U.S. government for purposes of the Sherman Act and thus may be an antitrust defendant. In addition, Congress should delegate to the Postal Rate Commission the power to enunciate the specific legal standards for predation and other acts of monopolization that would apply to the Postal Service's activities in markets outside its statutory monopoly.

IX. Conclusion

Much can be done to make the Postal Service a better public service agency of the federal government. Two overarching principles should guide specific recommendations for postal reform. The first principle is to define the Postal Service's mission so as to *remedy conditions of market failure*. That task encompasses universal service, quality of service, and the reasonableness of rates. The second overarching principle is to *avoid competitive distortions* through the pricing and product offerings of the Postal Service. That goal entails avoiding government production in markets that are or can be served satisfactorily by private firms, as well as avoiding discrimination among mailers and among competitors in secondary markets. A stronger Postal Rate Commission is

85. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, COMMITTEE ON COMPETITION LAW AND POLICY, PROMOTING COMPETITION IN POSTAL SERVICE 55 (Series Roundtables on Competition Policy No. 24, DAFPE/CLP(99)22, Oct. 1, 1999).

86. See *supra* note 83 and accompanying text.

necessary to ensure that the Postal Service operates consistently with these two general principles.

From those two principles flow a number of specific recommendations for making the Postal Service a better public service government enterprise. Those recommendations encompass universal service, costing, rate design and mail classification, the postal monopoly, and market entry and exit:

Postal Monopoly. To the extent that the Private Express Statutes and mailbox monopoly are to be interpreted through the promulgation of regulations, the PRC should be the federal entity issuing those regulations. On appeals of final agency actions by the PRC, the Department of Justice should urge the U.S. Court of Appeals to construe the postal monopolies as narrowly as possible. The PRC should enunciate the legal standard for predation and other acts of monopolization that would apply to the Postal Service's activities in markets outside its statutory monopoly.

Market Entry and Exit. The PRC should have the authority to approve, disapprove, or impose conditions on the Postal Service's entry into new markets. The PRC should have the power to compel the Postal Service's exit from any market that is outside the core services covered by its USO.

Universal Service. The PRC should supply a precise definition of the USO and require from the Postal Service an objective measure of the cost of the USO. The PRC should have the authority to set productivity and service-quality targets for the Postal Service. The USO should be thoroughly reevaluated, taking into account electronic substitution, among other market factors. The PRC should have the power to close post offices.

Costs. The PRC should be able to reject the Postal Service's proposed revenue requirement and order an alternative revenue requirement of its own determination. The PRC should have the power to subpoena the Postal Service to produce cost information and other relevant data. The PRC should establish, outside a rate case, the general methodology for calculating attributable costs and institutional costs, and for allocating institutional costs to classes of mail. The Postal Service should have the operational flexibility to cut large categories of costs. The PRC should be empowered to disallow the recovery through rates of any cost item—including labor costs and capital expenditures—that it determines to be excessive, imprudently incurred, or otherwise unjustified.

Rate Design and Mail Classification. The PRC should streamline rate cases by deciding costing and mail classifications in separate proceedings. The PRC should have the power to impose binding rates that the Postal Service cannot veto. The PRC should have final authority to establish mail classifications. The Postal Service should not fund its USO with monopoly rents from any class of mail subject to the Private Express Statutes. Rate discounts should be available to all mailers and be based on avoided costs, not negotiating or lobbying skill. Volume discounts unrelated to costs should not be allowed. The content restriction in letter mail should be eliminated to reduce a substantial hidden tax, promote mailer choice, and help realign the pricing structure for mail according to the service being delivered.

Postal Rate Commission. The powers of the PRC should be extended along the lines discussed above to allow it to control the regulatory parameters in compliance with which the Postal Service is allowed to operate.

The Role of Antitrust Law. Congress should overrule *Flamingo Industries* and clearly legislate that the antitrust laws apply to the Postal Service. The PRC should enunciate the legal standard for predation and other acts of monopolization that would apply to the Postal Service's activities in markets outside its statutory monopoly.

These proposals would benefit consumers and increase economic efficiency. The Postal Rate Commission would become a more effective regulator, and the Postal Service would become a better public service government agency.