

[Retyped]

[Stationery of Michael J. Regan, Director
International Postal Affairs, United States Postal Service]

May 14, 1999

Ambassador Michael Southwick
Bureau of International Organization Affairs
U.S. Department of State
Washington, DC 20520-0001

Dear Ambassador Southwick:

During the UPU Article 40 meeting at the State Department on April 21, it was generally agreed that eliminating the need for this article was dependent upon further progress in modifying the terminal dues structure. In view of the considerable efforts already expended in various forums to develop an appropriate terminal dues structure, even one limited to industrialized countries, the Postal Service cautioned other participants in the meeting about the feasibility of coming up with yet a new approach in any abbreviated time frame.

Time Frame for Terminal Dues Proposals

The UPU terminal dues proposal recently adopted for submission to the Beijing Congress was the result of over four years of work by a large number of UPU member countries. It has involved countless meetings, questionnaires, studies, financial analyses, and most importantly, a process of consensus building among all UPU member countries to find a satisfactory solution amenable to a majority of UPU members.

Even within Europe, due to the number of complex issues involved, 16 European postal operators have taken seven years to develop and revise the REIMS terminal dues system, which currently provides a transitional arrangement to terminal dues set at 70% of domestic tariff by 2001. For more than a year, the European Commission has been closely examining the impact of this agreement on mailers, public postal operators and private sector competitors. Specifically, the Commission still has concerns regarding the appropriate percentage of domestic tariffs and has called for each public postal operator to respond to this concern by developing a transparent cost-accounting system by the end of 1999. After reviewing the appropriate cost accounting data, the Commission will then determine what percentage of domestic tariffs should apply and whether this should be one percentage for all REIMS members or different percentages for different countries based on the cost accounting data. Article 40 protection will be maintained within the REIMS systems at least until the transition to the final percentage(s) of domestic tariffs is completed.

U.S. Postal Service Analysis

At the end of the April 21 meeting, the Postal Service was asked by FDX Corporation to consider the possibility of creating a terminal dues structure that could eliminate the need for Article 40 protection among countries participating in such an arrangement and that could serve as a basis for consultation among a group of industrialized countries.

The Postal Service has given due consideration to this task since our April 21 meeting. As a result of our further analyses, we believe that any terminal dues proposal we might develop on the basis of currently available data about postage rates and cost structures in other industrialized countries would not be satisfactory.

Results of our analyses indicated that with the elimination of Article 40, our domestic revenue base would be put at risk because of the gap between terminal dues and our domestic postage rates. In order to minimize this risk, we would be obliged to develop a terminal dues structure that reduces the gap between terminal dues and domestic rates to a point of relative insignificance. The proposal on Article 40 that we submitted to you on April 9 assumed terminal dues compensation from all countries to the U.S. Postal Service at a level close to eighty percent of our domestic rates at certain weight steps. Yet the financial impact analysis we provided with this proposal indicated that we would face losses to our domestic revenue base ranging from \$130 million to \$981 million at this level.

To minimize this risk, we would have to propose a terminal dues structure providing compensation at a level equivalent to one hundred percent of our domestic rates. We would then likely have to agree to compensate other industrialized countries at a similar level. This would drive up our international postage rates to levels well beyond anything contemplated in any terminal dues structure currently under consideration anywhere. This impact is real. It is significant and would serve the interests of private sector competitors by severely eroding the USPS international customer base and revenue sources.

Furthermore, it is not sufficient simply to propose a certain percentage relationship between terminal dues and domestic postage rates. We also face the question of how to properly map international mail flows into the appropriate domestic postage categories to determine that a given terminal dues structure is providing compensation at levels equivalent to domestic rates. The USPS domestic mail schedule is very complex and has numerous rate categories reflecting a wide range of weight steps and presort, barcode and distance-related discounts (see attached rate schedules of PRC Docket No. R97-1). There is no linear tariff formula that can take account of all these rates and classes of mail in order to eliminate the gap between terminal dues and domestic tariffs at a sufficient percentage of weight steps and mail classes to reduce the risk of arbitrage to sufficient levels. Any linearization of domestic weight step rates will define points above and below actual published domestic rates. The attached graph "*Relationship between Terminal Dues at 100% of Linear Tariff and actual domestic postage rates*" illustrates this arbitrage potential in a simplified form. Different linear tariff formulas may be more or less appropriate depending upon a particular country's domestic tariff structure. This is illustrated in the other two graphs attached which plot an existing linear tariff at 80% and 100% of domestic rates against the actual domestic rates at three weight steps. There is also the question of unpublished contract rates that are widely employed by a number of foreign public postal operators.

Impact on U.S. mailers

We have done some preliminary assessments of what the impact of this new terminal dues structure would be on international postage rates to some of the high-traffic, high-cost industrialized countries. For example, using the REIMS linear tariff formula set at 100% of domestic tariffs, international postage rates would need to increase 113% to Japan and up to 76% to particular countries in Europe.

Recommendation

A constructive approach on how to proceed would be for the interested agencies to jointly sponsor a study by a respected, independent company with experience in dealing with these issues. In our view, there is a need to further determine the cost structures, postage rates, and mail flow characteristics between interested industrialized countries. This would provide a more factual basis for developing recommendations on terminal dues and Article 40 policy and would establish a more solid basis with which to build consensus among other industrialized postal administrations. This approach is consistent with the terminal dues policy considerations within both the UPU and within REIMS. The UPU proposal to be considered in Beijing calls for an urgent study to be completed no later than 2002 to determine the appropriate percentage (or percentages) of domestic tariff to apply among industrialized countries. The European Commission has adopted a similar approach for the REIMS parties.

In any event, it simply does not appear realistic for us to attempt to move forward on a matter with such significant financial implications for mail users as well as for postal administrations without a more adequate and objective basis for our decisions. Not only do we need a more factual basis to guide our decisions, we need to ensure that all interested parties have an opportunity to provide input into the decision making process.

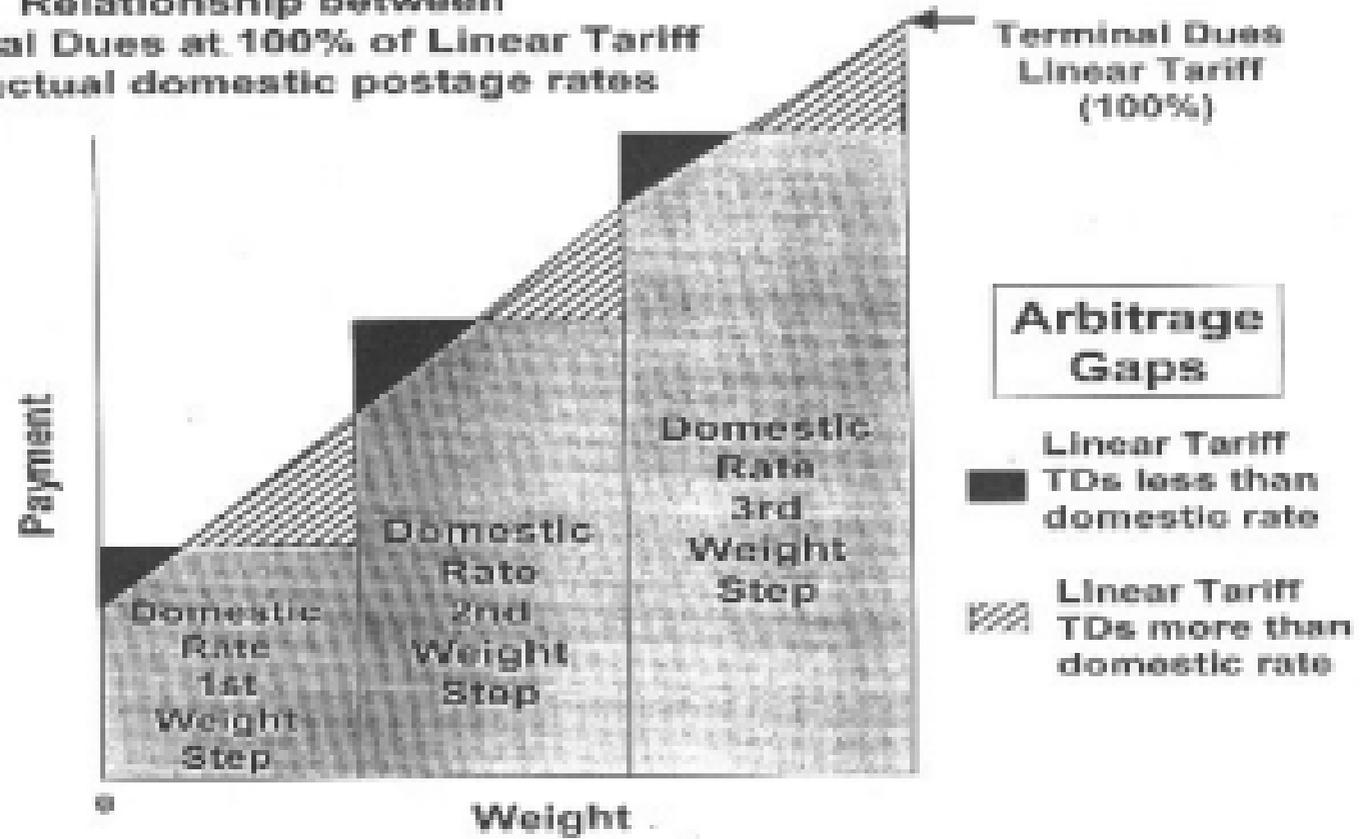
In conclusion, we believe that we have made a good faith effort over recent months to respond to numerous requests from FDX Corporation for information on particular issues related to Article 40 and terminal dues. We are proposing a realistic approach that recognizes the environment in which universal service providers are operating. I would appreciate the opportunity to discuss this way forward with you at your convenience.

Sincerely,

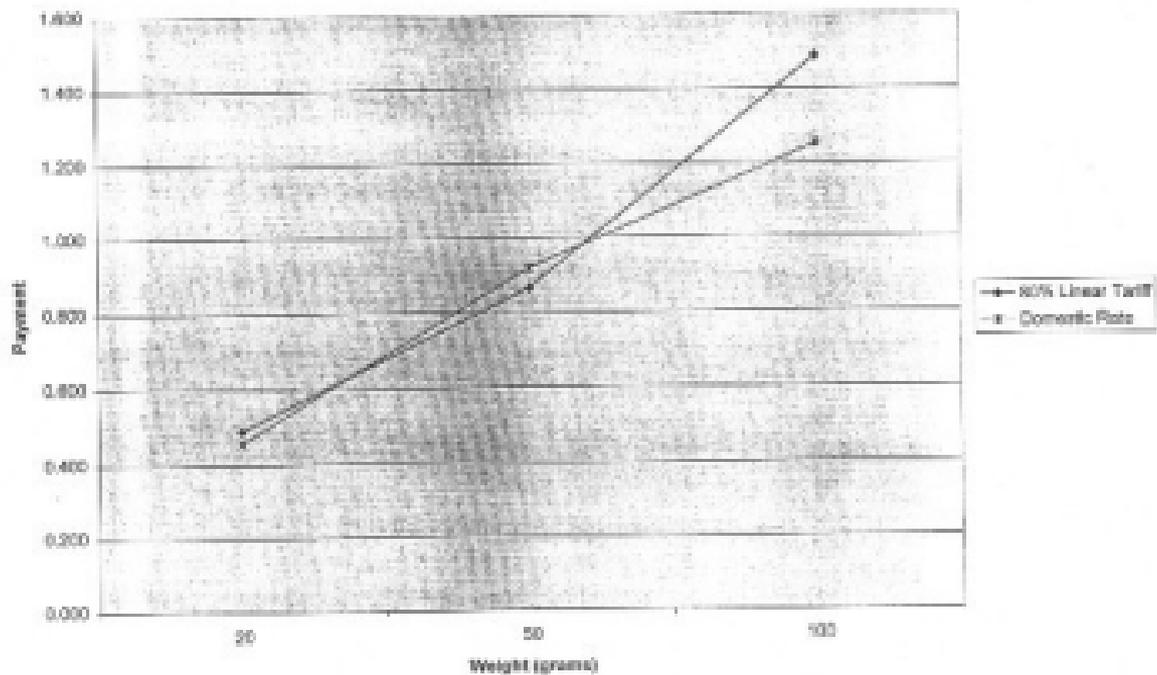
Michael J. Regan

Enclosures

Relationship between Terminal Dues at 100% of Linear Tariff and actual domestic postage rates



Relationship between linear tariffs and domestic postage rates



Relationship between linear tariffs and domestic postage rates

