

U.S. Department of Justice
Letter from Charles F. Rule, Assistant Attorney General, Antitrust Division,
to Carol T. Crawford, Associate Director, Office of Management and Budget
May 1, 1988

U.S. Department of Justice
Antitrust Division
Office of the Assistant Attorney General
Washington, D.C. 20530

May 1, 1988

Honorable Carol T. Crawford
Associate Director for
Economics and Government
Office of Management and Budget
Washington, D.C. 20503

Dear Carol:

As you know, the United States Postal Service and a number of foreign postal administrations have negotiated an agreement that would change terminal dues, the compensation they pay to one another for delivering international mail. Those proposed changes could affect the ability of private firms, known as remailers, to compete with USPS.

I have enclosed for your consideration a preliminary analysis prepared by our staff of the economic and competitive consequences of terminal dues. The staff proposes several provisions that are designed to preserve an efficient market and that we believe any terminal dues agreement should contain. I hope that our analysis will provide a useful framework in which to evaluate the issues. We would, of course, appreciate any suggestions, information, or additional analysis from your office, and from any other interested parties, that would help us to refine our analysis and proposals.

International mail is an area in which the President's policy of promoting private competition has been remarkably successful. Remail has had a profound effect on the price and quality of international mail service. When private competitors offered faster and less costly service than USPS for some types of mail, USPS had to improve its service and lower its prices. Apparently, USPS' outbound international mail rates are significantly above cost in part because the current rate of terminal dues inadequately compensates USPS for completing delivery of inbound international mail and USPS [1/2] makes up the shortfall through high charges for outbound mail. Remailers enabled U.S. mailers to avoid subsidizing inbound mail (and to take advantage of below-cost terminal dues). Consumers derived the benefits of competition in international mail because of the rivalry between

remailers and postal administrations.

The proposed changes would raise terminal dues substantially. To the extent that current terminal dues are below cost, the proposed changes would be beneficial so long as the new terminal dues rate does not exceed the cost of completing delivery of inbound international mail. Terminal dues that more accurately reflect cost will enable USPS to compete with its private rivals in a fairer forum and will increase allocative efficiency by causing prices more accurately to reflect the cost of service received. However, if the new terminal dues exceed the signatory administrations costs of completing delivery of inbound international mail, remailers might be unable to compete for reasons unrelated to their own efficiency. Such a development would injure consumers by eliminating the competitive market for international mail and could wipe out the gains we have achieved in the past few years.

In order to preserve efficiency-based competition in international mail, the United States should refuse to sign any agreement that does not protect remailers from terminal dues that are above administrations' cost of completing delivery of international mail. Unfortunately, it is probably impossible to use cost data to determine with a high degree of certainty whether the proposed terminal dues are above or below the signatories costs. First not clear how if any, overhead should be attributed to inbound foreign mail. Second, it would probably be impossible to gather the necessary data for all the relevant administrations in a form that allows comparisons. Third, it would be difficult to project future costs based on historical data. The proposed terminal dues would represent a dramatic change and could cause mail flows to change markedly, making cost estimates based on current mail flows inaccurate after the market adjusts to a new cost structure. Future costs can also be influenced by exchange rates which are impossible to predict. Finally, any attempt to measure cost necessarily focuses average cost per piece and average terminal dues per piece. It is likely, however, that the new terminal dues would exceed the cost of completing delivery of some types of mail and fall short of cost for others, even if terminal dues equal average cost. Thus, terminal dues that equal average cost could give an advantage to postal administrations, unrelated to efficiency, for some types of international mail and to remailers for other types of mail. [3]

In view of the difficulty of protecting competition through regulatory rules based on cost data, we propose that the United States insist that any agreement to change terminal dues contain provisions designed to preserve competition. Specifically, we propose that remailers be permitted to post mail in the domestic mail system of the country of destination at rates comparable to domestic mail. We expect that domestic postal rates are not likely to exceed the cost of delivery significantly. In addition, we support removing any restraints on competition in international mail. Thus, we suggest that any agreement that the United States enters should include pledges that all signatories will: 1) allow private companies to collect international mail and ship it out of the country, 2) accept international mail from private companies, 3) refrain from any discrimination in terms, conditions or rates, between domestic mail and remail, and 4) refrain from invocation of Article 23.4 of the UPU convention and accept remail from other administrations.

Since we might not have all the pertinent facts at this time, our proposals are necessarily tentative. Nonetheless, I believe that the enclosed analysis by our staff will provide a useful point

for beginning discussions of the proposed agreement.

Sincerely,

Charles F. Rule
Assistant Attorney

enclosure

EVALUATING A PROPOSED AGREEMENT ON TERMINAL DUES

The United States Postal Service (USPS) and the Executive Office of the President are now considering a proposal to change the compensation that USPS and foreign postal administrations pay to one another for the delivery of international mail. This memorandum is a preliminary analysis of the ways in which the proposed change could enhance or impair competition and efficiency in the international mail system.

This analysis is necessarily incomplete because much information that would be useful in evaluating the proposed changes is not available at this time. Among other things, we have not seen the text of the proposed agreement, any record of the negotiations that led to the proposal, or any analysis of the costs, volumes, sources, or destinations of mail that might be affected by the proposed changes. Moreover, we have little information about the problems with the current system that the proposed changes are meant to address, or about other solutions to those problems that may have been considered and rejected. Because of these information deficiencies, the ensuing analysis and recommendations are offered tentatively. [2]

I. INTRODUCTION AND RECOMMENDATIONS

Postal administrations only compensate one another for completing delivery of international mail when one administration sends more mail (by weight) to an administration than it receives from that administration. The administration that sends the greater weight pays the other "terminal dues.. The current compensation system is a per-kilogram charge that is uniform for all countries and all types of mail even though delivery costs vary widely for different types of mail and for different countries. Current terminal dues are too low to compensate the post offices of developed nations adequately for completing delivery of a substantial portion of their incoming international mail. As a result, many post offices set their international postage rates (on outgoing mail) high enough to make up for the shortfall resulting from completing delivery of incoming mail. Remailers offer consumers a way to take advantage of below-cost terminal dues in foreign countries and to avoid above-cost rates on outgoing mail by carrying mail to a third country postal administration willing to transship the mail for a price slightly above terminal dues.

Several postal administrations have responded to the situation by proposing a higher terminal dues rate and have invited USPS to participate in the new scheme. Raising terminal dues would promote efficiency if the new terminal dues more accurately reflect administrations' cost of completing delivery of international mail. While more efficient pricing by postal [3] administrations might harm remailers, U.S. competition policy is designed to protect consumers by promoting efficiency, rather than to protect one group of competitors over another. If, however, the new terminal dues exceed postal administrations' cost of completing delivery of international mail, the result would promote inefficient pricing, substantially reduce the opportunity for private firms to compete with postal administrations, and deny consumers the benefits of price and service rivalry.

This Administration has expended considerable effort to foster a competitive market for

international mail. Accordingly, we should be concerned lest postal administrations seek to drive remailers out of business by raising terminal dues above cost. While analysis of the proposed terminal dues through direct examination of cost data is probably impossible, there is an indirect way of making sure that remailers are not unfairly driven out of the market by postal administrations.

Remailers might be able to nullify any anticompetitive effects of above-cost terminal dues if they can ship mail directly to the destination country and then are accorded the same rates as domestic mail within that country. To the extent that remailers are required to pay the destination country's domestic rates, rather than terminal dues, the danger to efficient remailer competition that would be posed by above cost terminal dues is eliminated. Accordingly, we suggest that the participants in any agreement to adjust terminal dues pledge to: 1) allow private companies (remailers) to collect international mail and ship it [4] out of the country, 2) accept international mail from private companies, and 3) refrain from any discrimination in terms, rates, or conditions, between domestic mail and international mail shipped by any public or private carrier.

II. THE CURRENT SYSTEM

A. Terminal Dues

Mail exchanges among national postal systems are governed by international conventions, negotiated every five years by the Universal Postal Union (UPU). Under the UPU Convention, administrations do not reimburse one another for completing delivery of international mail on a per-piece basis; rather, bilateral exchanges are "netted-out" by weight and the administration that sends the most reimburses the other. Article 64 of the Universal Postal Convention provides that:

1 [E]ach administration which, in its exchanges by air and surface means with another administration, receives a larger quantity of letter-mail items than it sends shall have the right to collect from the dispatching administration, as compensation, a payment for the costs it incurs for the excess international mail received.¹

When a country sends more mail to another country than it receives from that country, the reimbursement for the net difference is [5] called "terminal dues.. Terminal dues are now \$3.56 per kilogram, or about 5.5 ¢ for the average weight letter.²

¹ Acts of the Universal Postal Union, Revised at Hamburg in 1984, Vol. 2, Universal Postal Convention, Art. 64.

² Terminal dues are set in gold francs and converted to Special Drawing Rights (a composite of several currencies administered by the International Monetary Fund). Terminal dues are currently eight gold francs per kilogram. One SDR equals 3.061 gold francs. On March 2, 1988, one SDR equaled \$1.36. Thus, terminal dues are about \$3.56 per kilogram. According to USPS, the average letter sent from Canada to the United States weighs 15.4 grams. If the average international letter is the same weight, terminal dues are about 5.5¢ for the average letter.

The cost of completing delivery of international mail varies widely from one type of mail to another, and from one country to another. Since terminal dues are uniform for all types of mail and for all countries, terminal dues are sometimes greater than, and sometimes less than, the cost actually incurred to complete delivery of individual items. According to USPS, the current terminal dues rate is too low to compensate USPS and most western European administrations fully for their costs of delivering some types of international mail.³ , These administrations are, in effect, providing subsidies to mailers who send international mail into their countries or to the administrations of originating countries (or both) because they are charging less for delivery than it costs them to provide that service. [/6]

USPS is required to establish domestic postal rates equal to the cost of the services provided.⁴ As a result, international service must pay its own way, and USPS must compensate for the losses it incurs completing delivery of inbound international mail by setting rates for outbound international mail service above the cost of providing the latter service. It is our understanding that some western European administrations engage in similar practices.

The combination of terminal dues that are below the cost of completing international mail delivery and rates for outbound international mail that are above cost has created profitable opportunities for remailers. Remailers are private companies that collect mail from their customers, sort it, bag it by country of destination, and deliver it to a foreign postal administration. Remailers occasionally deliver mail directly to the postal administration of the country of destination. Usually, however, remailers deliver mail to the postal administration of a third country, which combines the mail in its outbound international mail. The costs incurred by the third country's postal administration in providing this remail service are relatively low – transportation and terminal dues. Remailers can collect and deliver mail in the country of origin, deliver it to a third [/7] country's postal administration and pay the latter's cost (including a profit) for less than the amount charged for international mail by the postal administration in the country of origin. In effect, the subsidy provided by the country of destination is captured by the remailers, their customers, and the postal administrations with which they cooperate, rather than by the postal administration of the country in which the mail originates.

B. Postal Administrations' Response to Remail

Several postal administrations have lost substantial volumes of international mail to remailers. They responded to the loss of business in several ways. One response was to attempt to outlaw the practice. For example, in 1985, USPS proposed regulations to prohibit remail as an

³ It is more expensive to sort and deliver a kilogram of lightweight mail (containing many pieces) than of heavy mail (containing fewer pieces). In the parlance of the UPU, light mail is known as LC, for lettres st cartes (letters and cards), and heavy mail is referred to as printed matter or AO, for autres objets (other objects). USPS maintains that terminal dues are currently insufficient to compensate it for completing delivery of LC.

⁴ 39 U.S.C. § 3622. *National Association of Greeting Card Publishers v. United States Postal Service*, 607 F. 2d 392 (D. C.. 1979).

unlawful infringement on its monopoly over the domestic carriage of letters.⁵ That proposal was opposed by many mailers⁶ and the Antitrust Division.⁷ The Postal Service responded by withdrawing its initial proposal and subsequently proposed and adopted regulations that explicitly allowed remail.⁸

Another response to remail on the part of postal administrations was to offer better service and lower prices to large-volume international mailers. According to one publication, for mailers "with sufficient overseas volume, postage has been cut [9] in half -- and [USPS] has improved delivery.⁹ Indeed, the Chairman of the Board of Governors of the Postal Service stated that "the competition from private remailers has already spurred us [USPS] on to improve our own efforts and be more competitive in providing international mail services. . . ." ¹⁰

Apparently, improved international mail service was insufficient to stem the flow of remail.

⁵ 50 Fed. Reg. 41,463. USPS' monopoly is granted by the Private Express Statutes ("PES"). 18 U.S.C. S 1694, 1696. USPS asserts it can suspend the PES where "the public interest. so requires. 39 U.S.C. § 601(b). In 1979, USPS suspended the PES for "extremely urgent letters.. An ambiguity in the regulations allowed remail. Mail is "extremely urgent. if the price is twice that of domestic first class mail. 39 C.F.R. § 320.6(c). A package of letters is considered one letter if all the letters are delivered to--a single place. Id. International mail is "delivered. when it reaches its point of departure from the country. 39 C.F.R. § 320.6(b)(2). By treating a consolidated package as one letter, remailers could satisfy the cost test and charge a lower rate than if the postage payable were calculated separately for each piece of mail in the package because postage is based on one ounce increments, but many letters weigh less than one ounce and if several are weighed together, the total is less than if each were counted as one ounce. Thus, remail was arguably legal so long as the remailer charged twice the domestic first class rate for each bundle of letters. When USPS realized the impact of the ambiguity, it proposed regulations that would have made remail a violation of the PES.

⁶ See, e.g., Comments of the New Postal Policy Council and Comments of The Chase Manhattan Bank, N.A. Before the United States Postal Service, In the Matter of Restrictions on Private Carriage of Letters; Proposed Clarification and Modifications of Definition and Regulations on Extremely Urgent Letters, December 12, 1985.

⁷ Comments of the United States Department of Justice Before the United States Postal Service, In the Matter of Restrictions on Private Carriage of Letters; Proposed Clarification and Modifications of Definition and Regulations on Extremely Urgent Letters, December 12, 1985.

⁸ 51 Fed. Reg. 29,636 August 20, 1986. See also Statement of John R. McKean, Chairman, United States Postal Service Board of Governors, on Remail Issue, March 4, 1986 ("[R] email services would appear to advance consumer welfare while at the same time fostering innovation and economic efficiency. . . . [A]ny attempt to suppress this kind of competition would [not] advantage the long-term objectives of the Postal Reorganization Act or otherwise enhance the welfare of our customers and the American people. . ."). 51 Fed. Reg. 9852 (March 21, 1986).

⁹ "Unions Attack International Remail., Business Mailers Review, Vol. 8, No. 23, December 7, 1987, p. 1; See also Business Mailers Review, December 8, 1986 (-Competition for international mail is stirring postal folks to get off their duffs.").

¹⁰ Statement of John R. McKean, Chairman, United States Postal Service Board of Governors, on Remail Issue, March 4, 1986, 51 Fed. Reg. 9853.

The British Postal Service wrote in March 1987 that "[t]he amount of activity by private remailers in Europe is rapidly on the increase. . . . Airmail letter traffic, the traditional preserve of postal administrations, is now being strongly attacked by large, multi-national companies."¹¹ The British invited representatives of several postal administrations to a meeting in London in April 1987 to "consider whether there is a common policy we can adopt to counter the activity of these companies."¹² [/10]

One result of the April meeting in London was the formation of a working party consisting of representatives of the post offices of Belgium, Finland, France, Great Britain, The Netherlands, Sweden, and Switzerland. The working party met several times over a period of eight months and considered several new terminal dues structures. One proposal included a "code de bonne conduite" (code of good conduct) that would have prohibited postal administrations from seeking the patronage of remailers or offering remailers favorable rates.¹³ USPS assures us that the [/11] proposed agreement does not contain such a provision or any agreement not to compete. The Department of Justice would urge that the Administration reject any postal agreement that contained such provisions.

¹¹ Letter from M. Goss, Acting Head of International Relations Division, Royal Mail Letters, to postal administrations of Belgium, Denmark, Finland, France, Germany, Ireland, Italy, The Netherlands, Norway, Portugal, Spain, Sweden, and Switzerland, March 12, 1987.

¹² Id. According to USPS, the meeting was held under the auspices of the European Council of Posts and Telephones. The United States and Canada were invited to attend as "observers."

¹³ The September 10, 1987 report of the Working Party stated:

A change of terminal dues is one way of dealing with the remail problem. In order to get the full effect of this change it is also necessary for Postal Administrations to agree upon applying the same practices

For this purpose all Administrations signatories to the coming terminal dues agreement should agree to apply the following practices. . . ["]

- a) not to take the initiative of marketing, . . . or by working or entering into contracts with operators in the country, customers belonging to another Administration
- b) not to enter into contracts of favourable terms with couriers, road haulers, or any third party speculating on the differences in postal charges between Administrations
- c) not to set international rates below the level of their inland rates
- d) to refrain from all speculations on compensatory rates where this is to the detriment of another Administration. . . .

"Report of the Working Party on Terminal Dues and a New Business Letter Service," August 27, 1987.

C. The Proposed Agreement

On October 27, 1987, a group of postal administrations formulated a proposal to adjust terminal dues.¹⁴ The new terminal dues would be set at rates higher than those currently in force and would distinguish between heavy and light pieces by introducing a per piece charge along with a per kilogram charge. The new rate would be .37 gold francs per piece and 3.75 gold francs per kilogram. At March 2, 1988 exchange rates, that was 16.4¢ per piece and \$1.67 per kilogram. Thus, terminal dues would be 19¢ for a 15 gram letter. According to USPS, the working party contemplated that the new terminal dues would be implemented through a series of bilateral agreements among countries that decide to participate. USPS and OMB are now considering whether the United States should join the new system by entering into bilateral agreements with other countries.[/12]

III. THE EFFECTS OF COMPETITION IN THE
DELIVERY OF INTERNATIONAL MAIL

A. Benefits of competition

It is the policy of the United States to promote and preserve competition as a means of fostering productive efficiency, which in turn is deemed a means of increasing consumer welfare. The purpose of this memorandum is to evaluate whether changes in terminal dues will promote a more efficient international mail system. An efficient international mail system will provide services at the lowest possible cost of economic resources, to the benefit of both senders and recipients of international mail. A corollary to this, as we explain more fully below, is that senders of international mail should pay prices no greater than, and no less than, the cost of the services they purchase.¹⁵ [/13]

The most effective means of promoting an efficient international mail system is to permit competitive forces to operate freely. Competition is a fundamental tenet of American economic

¹⁴ The group included the members of the working party and four "observers" Australia, Canada, Japan, and the United States.

¹⁵ This analysis does not consider two factors that may be of interest to some parties. First, we do not consider whether the proposed changes will increase or decrease USPS revenues compared to those of foreign administrations, increase or decrease revenues of US-based remail firms compared to those of foreign firms or USPS, or increase or decrease prices paid by US mailers compared to those paid by foreign mailers. We do not consider these matters for several reasons. First, an efficient international mail system best serves both senders and recipients of international mail. US-based recipients derive economic and other benefits, such as the increased flow of information, if foreign mailers pay lower rates. Lower postal rates in foreign countries will be of benefit to the foreign offices of US-based firms and US citizens who--post mail abroad. On the other hand, higher revenues for USPS or for US-based remailers are likely to mean higher costs for US-based mailers. It would be very difficult, if not impossible, to accurately assess short-term costs and benefits. Second, we do not believe that the international mail system should be biased in any way towards either postal administrations or remailers. International mail should be carried by the party that can provide that service at the lowest cost, be it a postal administration or a private firm.

policy. The premise is that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic, political, and social institutions.¹⁶

A producer must set its prices closer to cost when it faces competition than when it does not. Price competition limits the ability of a producer to raise its prices. If it sets its prices too high, consumers will take their business elsewhere. Competition among producers also tends to result in the development of new goods and services. Prodded by the fear of losing business to rivals, producers constantly search for ways to increase their business by offering superior products or services and by reducing their costs. Experience reveals that when a non-competitive market becomes competitive, prices are reduced, service is generally improved, and resources are allocated more efficiently. The benefits of competition are illustrated by the success of remailers in forcing USPS to improve its international mail service and to lower some international postal rates.¹⁷

Even where a product or service is offered by a regulated utility, such as the Postal Service, competition will have the effect of moving prices toward the costs of an efficient producer. Indeed, firms will enter a market to compete against a utility if, and only if, they believe they can provide the service to some substantial group of customers at a lower price than the utility charges (either because the utility charges prices above its costs or because the entrant has lower costs than the utility).

Permitting firms to compete with the utility will provide an incentive for the utility to charge each customer a price that reflects the cost of providing service to that customer. Utilities, for political as well as administrative reasons, often charge a uniform price to all customers who purchase a particular service even though the service can be provided at a lower cost to some customers than to others. In other words, some customers pay more than the cost of the services they consume while others pay less than cost. In a competitive market, rival firms are likely [15] to identify these situations and offer service at prices lower than the incumbent firm's prices to those customers who are being overcharged.¹⁸ As a result, all customers pay prices that are close to the cost

¹⁶ Northern Pacific Railway v. United States, 356 U.S. 1, 4 (1958).

¹⁷ Chairman McKean of the USPS Board of Governors stated that "private sector competition with the Postal Service in the provision of international remailing services can -- and already does -- produce significant benefits for the public. Ultimately, even the Postal Service itself can benefit from this kind of competition.. Statement of John R. McKean, Chairman, United States Postal Service Board of Governors, on Remail issue, March 4, 1986, 51 Fed. Reg. 9853.

¹⁸ A competitive market will not necessarily result in prices precisely equal to costs for all services. Some cost differences are likely to be so insignificant, or so difficult to measure, that it is not worth the effort to attempt to reflect those differences in different prices.

of the services that they purchase and resources are allocated more efficiently.¹⁹

B. Effect of Terminal Dues on Competition

Divergence between the price of a service or product and the cost of providing that service or product leads to an inefficient allocation of economic resources.²⁰ Under the current terminal dues system, terminal dues are uniform for all types of international mail and for all postal administrations, even though their costs vary widely. These differences between prices and costs cause substantial allocative inefficiencies.

Divergence between terminal dues and the cost of completing delivery of international mail also affects the abilities of remailers and postal administrations to compete with one another. In general, if terminal dues are above a postal administration's cost of completing delivery of inbound international mail, that administration can use the extra revenue from incoming mail to subsidize outgoing mail, thereby obtaining a cost advantage, unrelated to efficiency, over remailers carrying mail from its country. Conversely, if terminal dues are below an administration's cost of completing delivery of inbound international mail, the administration will have to recoup those losses by increasing the rates on outbound mail, thereby conferring on remailers a cost advantage, unrelated to efficiency, over that administration for the carriage of mail out of its country.²¹

The current terminal dues system favors remailers if terminal dues are below most countries' cost of completing delivery of international mail. The proposed agreement would be beneficial if it eliminates or reduces such an artificial advantage. In addition, the agreement could lead to lower

¹⁹ Alfred Kahn, *The Economics of Regulation: Principles and Institutions*. Volume II (1971), pp. 220-223. There are two situations in which consumers will not gain from unrestrained competition with a utility. One is when the utility is required to serve some consumers at a price below cost, but could not do so without monopoly revenues generated serving others. That exception does not apply to international mail where the statute requires USPS to set rates that cover its costs for each domestic service that it provides. The other exception is when the market is a natural monopoly (one in which it is less costly for one firm to supply a service than it would be for more than one). *Id.* at 223-243. That exception probably does not apply here either; we have no reason to believe that international mail is a natural monopoly.

²⁰ If a good or service is priced above marginal cost, output will be reduced and consumer satisfaction diminished. Conversely, if the price consumers pay for a particular service is below its marginal cost, consumers will use that service more frequently than if the price equaled marginal cost. This overuse results in an inefficient allocation of resources because more resources are allocated to the production of this good than would occur if the consumers of the good bore the full burden of the costs of its production.

²¹ These advantages are illustrated in Appendix A. They arise from the fact that postal administrations, but not remailers, obtain profits or suffer losses from the delivery of inbound international mail. The artificial cost advantages exist regardless of mail flows. However, since postal administrations generally exchange service and only pay terminal dues when there is a difference between the volume of mail sent by one and the volume of mail sent by the other, mail flows can affect the size of the advantage an administration or remailer will derive from terminal dues that do not equal cost.

outbound international mail prices in countries that are "net importers" of mail by reducing the need for administrations to price international mail high enough to make up any shortfall they incur completing delivery of international mail at artificially low terminal dues.

Raising terminal dues is, however, not without risk. If the new terminal dues exceed an administration's cost of completing delivery of international mail, the agreement could inhibit private competition with that administration for international mail, and could be more harmful to consumers than the present system. In a system that favors remailers, consumers benefit from the competition among remailers, whereas in a system that favors post offices, consumers face a single monopolistic supplier. Even if the postal monopolist did not seek to earn a supra-competitive return, as would be the goal of a private monopolist, a postal monopolist is likely to have higher costs than it would if it faced competition because it would have less incentive to reduce costs and to innovate.²²

IV. AVOIDING ANTICOMPETITIVE EFFECTS THROUGH MARKET FORCES

A. Difficulties in Evaluating the Agreement

Any terminal dues rate that does not reflect costs accurately impairs the efficient operation of the market by imposing artificial costs on either remailers or postal administrations. USPS has indicated that the current terminal dues rate is substantially less than the costs incurred by it and western European postal administrations in delivering inbound international mail. USPS has also concluded, preliminarily, that the proposed terminal dues rate, though higher than the current rate, will also be lower than the costs of the affected postal administrations. If true, adoption of the proposed rates would reduce the artificial cost advantages currently enjoyed by remailers and would improve the efficiency of the international mail system.

Unfortunately, any precise comparison of the proposed terminal dues to the costs of participating postal administrations is extremely difficult, if not impossible. One major difficulty is the requirement of allocating costs among the different types of mail that are handled by a unitary postal system. From an economic perspective, there is no inherently "correct" formula for allocating such costs.²³ Even if an appropriate formula could be agreed on, precise cost allocations would require massive quantities of data -- data that might not be available at all, and that are not likely to be kept in a consistent manner by all of the relevant postal administrations.

A second major obstacle arises from the necessity to project future costs on the basis of

²² Our focus in this analysis is on ensuring that the proposed agreement does not unfairly reduce remailers' ability to compete. We are no less opposed to unfair inhibition of USPS' ability to compete with remailers. We are, however, less afraid that an agreement would create unfair restraints on postal administrations' ability to compete with remailers because postal administrations, not remailers, negotiate such agreements, and we assume that they would not place unfair burdens on themselves.

²³ See, e.g., S. Moriarity, ea., *Joint Cost Allocations* (1981); P. Young, ed., *Cost Allocation: Methods, Principles, Applications* (1985).

historical data. The proposed terminal dues would represent a substantial change from the current system; mailers, postal administrations, and remailers will revise their practices in response to those changes. Cost estimates based on historical mail flows will therefore be inaccurate when the market adjusts in response to changed economic incentives. Cost estimates will also depend to a large extent on international exchange rates, which are likely to rise or fall in the future. [/20]

Another problem with attempting to measure costs is that such measurement necessarily focuses on average cost per piece and average terminal dues per piece. However, to the extent that different types of mail have different cost characteristics it is possible that the new terminal dues would be above cost for some types of mail and below cost for others, even if terminal dues approximate average cost. If that is the case, the new terminal dues would reduce competition by giving an advantage, unrelated to efficiency, to remailers for some types of mail and to postal administrations for other types of mail. Thus, examining average costs could lead to a misplaced confidence in the benefits of the proposed agreement.²⁴

The extreme difficulty of measuring costs is illustrated by the time-consuming and complex proceedings before the Postal Rate Commission for establishing domestic postal rates. A reliable measurement of international mail costs would require data and analysis, roughly comparable to that required in domestic rate-making proceedings, for each of the countries participating in a new terminal dues agreement.

The difficulty of precisely measuring costs creates a substantial risk that the proposed terminal dues will exceed the costs of delivery incurred by some postal administrations for some classes of international mail. Such rate could preclude remailers [/21] from carrying a substantial volume of international mail, even if they could do so more efficiently than the postal administrations with which they compete. The resultant diminution of competition could have the effect of substantially increasing the costs of mailers in the U.S. and abroad.

B. Preserving Competition

In view of the difficulty of making a prediction of the effect of terminal dues based on actual cost data, and the risk to competition posed by above-cost terminal dues, we believe that any terminal dues agreement between USPS and a foreign postal administration should include safeguards to ensure that remailers are allowed to engage in remail activities and are not forced to pay terminal dues that are above costs. The most effective safeguard, in our view, would be assurances that remailers would be permitted to post mail in the domestic postal system of the country of destination, at the rate that would be charged for comparable domestic mail.²⁵ [/22]

²⁴ See Example Six, Appendix A.

²⁵ This proposal might not succeed in preserving competition in international mail if: 1) remailers are currently deriving considerable cost savings through the use of overseas airport "hubs" and consolidation of their mail volume with the international mail of other postal administrations, and 2) those cost savings would no longer be available. Unfortunately, we do not have enough information at this time to know whether the proposed

This protection, to be fully effective, requires that each postal administration participating in a new terminal dues agreement: 1) allow private companies to collect international mail and ship it out of the country, 2) accept international mail from private companies, and 3) refrain from any discrimination, in terms, conditions, or rates, between domestic mail and remail.

Remail has created competition between postal administrations and private firms (with postal administration partners) for international mail. We believe this development is beneficial and urge that any agreement include guarantees that would allow the continuation of efficiency-based competition. Such a guarantee would require a statement that all signatories will accept remail. Absent such a guarantee in any new agreement on terminal dues, it cannot be assumed that the various postal administrations will not try to inhibit remail. Under Article 23.4 of the UPU Convention, a postal administration is not required to accept remail:

A member country shall not be bound to accept, forward or deliver to the addressees letter-post items which senders post or cause to be posted in large quantities in a country other than the country where they reside. The administration concerned may send back such items to origin or return them to the senders without repaying the prepaid charge. [23]

While USPS has stated that it will not ask other administrations to enforce Article 23.4 against retailers,²⁶ there is no assurance that other administrations (or USPS) will allow remail to enter their countries. Thus, we believe that any agreement on terminal dues should include a agreement not to invoke Article 23.4 to bar remail.²⁷

Allowing remailers to pay domestic rates in the country of destination, rather than terminal dues, provides several advantages. First, although there is no guarantee that domestic rates in all countries do not exceed costs, postal administrations are likely to have political incentives to set domestic rates at reasonable levels.²⁸ The political and economic incentives may [24] well be the

agreement could cause remailers to lose any advantages they have gained from devising efficient systems for shipping international mail.

²⁶ Letter from Postmaster General Albert V. Casey to Secretary of State George Shultz, March 3, 1986 ("the Postal Service will not be asking other postal administrations to take any action under this provision.")

²⁷ Remailers might be able to avoid any competitive disadvantage imposed on them by higher terminal dues if they send mail through postal administrations that do not agree to the new terminal dues, choosing instead to continue paying (or receiving) terminal dues at current rates. Unfortunately, preservation of competition in this way would continue any disadvantages of the current system.

²⁸ Our proposal is based on reasoning similar to that articulated by the Department of Commerce that domestic postal rates are not likely to exceed the cost of delivery by any substantial degree. The Department of Commerce points out that the current system, in which administrations exchange delivery service, causes some mailers (or administrations) to subsidize others whenever all administrations do not have the same cost of

opposite of those that influence terminal dues, since high terminal dues will provide an artificial cost advantage to postal administrations over their competitors. Second, experience to date indicates that domestic rates are more likely than terminal dues to reflect the costs of carrying difference classes of mail. For example, in the United States domestic rates are adjusted for mail that is pre-sorted, uniform in size or weight, and properly addressed and coded.²⁹ The proposed terminal dues, on the other hand, distinguish classes of mail only on the basis of weight and number of pieces. Since domestic rates could be [25] more closely tailored to relative cost, mailers paying domestic rates would face more appropriate economic incentives, and allocative efficiency will be increased. Third, domestic rates can be adjusted unilaterally as circumstances require. Terminal dues are likely to be more difficult to adjust over time, since bilateral or multi-lateral negotiations will be required. Similarly, fluctuations in currency exchange rates will be automatically reflected in the costs of remailers who pay domestic rates. Therefore, over time, domestic rates are likely to respond more rapidly to changes in costs, thereby enhancing efficiency.³⁰

V. CONCLUSION

The current terminal dues structure produces distortions in the economic structure of the international mail system. Since terminal dues do not accurately reflect costs, the current system causes a subsidy to flow from some parties to others, provides artificial cost advantages to remailers in some cases and to postal administrations in others, and generally impairs the efficient operation of the international mail system. The proposed change in terminal dues shares many of the defects of the current system and entails a substantial risk that remailers will be excluded from segments of the international mail market as a result of artificial cost disadvantages. To minimize that risk, any agreement between USPS and a foreign postal administration to adopt the proposed terminal dues should include concrete assurances that remailers will be permitted to collect mail in the country of origin, carry it to the country of destination, and post it at the domestic postal rate of the country of destination. Any agreement should also include an assurance that administrations will accept

completing delivery of inbound mail.

The most reasonable alteration of terminal dues would be for each individual country to adopt a inbound

²⁹ USPS, for example, sets rates based upon the weight of a piece of mail and, for some classes of mail, the distance a piece must travel. In addition, it offers discounts to mailers that sort mail by zip code or carrier route. USPS has literally hundreds of rates.

Our proposal could not successfully preserve competition if remailers delivering mail to a destination country would be forced by that country's postal administration to pay for services they do not receive (such as collection and sorting). We do not have enough information at this time to know if the participants' domestic rate schedules would impose such charges.

³⁰ For the same reasons, we believe that if the new terminal dues exceed cost, postal administrations, and not just their private competitors, should be able to take advantage of lower domestic rates.

international mail from all carriers, regardless of its origin.

We emphasize again that these conclusions and recommendations are necessarily tentative. The existing international mail system reflects the interaction of complex economic, historic, and political factors, all of which influence the desirability and feasibility of proposed changes in that system. Our understanding of those factors is admittedly incomplete; we hope that further information and analysis from others who are evaluating these issues will address those considerations.

APPENDIX A

THE EFFECT OF TERMINAL DUES ON INTERNATIONAL MAIL PRICES

The effect on competition of terminal dues that do not equal cost is most easily illustrated by several examples of mail exchanges between two countries, Red and Blue. The cost of international mail service includes the cost of collecting, sorting, and transporting mail to the postal system of the destination country. These costs are incurred by both remailers³¹ and the postal administrations with which they compete; to simplify the analysis, we assume here that these costs are identical for remailers and for postal administrations, i.e., that both are equally efficient producers. In the examples here, the coats of collecting, sorting and shipping mail are ignored, so that the effect of terminal dues will not be obscured.

Example One: Terminal Dues Below Cost

Remailers gain an advantage unrelated to efficiency when terminal dues are below cost.

Red and Blue both incur costs of 50¢ per unit to complete delivery of inbound international mail and each country sends 1000 units of mail to the other. Terminal dues are 25¢ per unit. Red [28] and Blue each have a total cost of \$500 for providing international mail service (the cost of inbound delivery of 1000 units at 50¢ per unit). Neither receives terminal dues because they each send as much as they receive, leaving postage as the only source of revenue for international mail. Thus, to cover their costs for international mail, each must charge 50¢ per unit. A remailer can ship mail from Red to Blue (or from Blue to Red) through Yellow. Yellow will charge the remailer its cost of sending mail to Blue (the cost of sending one more unit of mail to Blue). As long as the cost of sending an additional unit of mail from Yellow to Blue, plus the cost of transport from Red to Blue via Yellow, rather than directly between Red and Blue, is less than 25¢ (the difference between

³¹ Remailers can incur some of these costs indirectly. For example, when remailers send mail to-the country of destination via a third country postal administration, that administration incurs shipping costs that it passes on to remailers in its rates.

Red's cost and terminal dues), the remailer will have a cost advantage unrelated to efficiency.³²

Example Two: Terminal Dues Above Cost

Postal administrations gain an advantage unrelated to efficiency when terminal dues exceed cost. [29]

Red and Blue both incur costs of 50¢ per unit to complete delivery of international mail and each country sends 1000 units of mail to the other. Terminal dues are \$1.00 per unit. As in Example One, the total cost to both Red and Blue of international mail service is \$500. Neither receives terminal dues because they each send as much as they receive. To cover their costs for international mail, each must charge 50¢ per unit. A remailer, on the other hand, that ships mail from Red to Blue through Yellow will have costs equal to the terminal dues rate (see Example One) of \$1.00 per unit and thus will not be able to compete with the postal administrations who have costs of 50¢ per unit and thus will not be able to compete with the postal administrations who have costs of 50¢ per unit.

Example Three: Terminal Dues Below Cost and Mail Flow Imbalance

The effect of terminal dues on competition is not changed if Blue sends more mail to Red than Red sends to Blue; if terminal dues are below cost, retailers are given an artificial advantage over postal administrations.

Red and Blue incur costs of 50¢ per unit to complete delivery of international mail. Terminal dues are 25¢ per unit. Red sends 500 units of mail to Blue. Blue sends 1000 units of mail to Red. The total cost to Red of delivering the international mail for Blue is \$500 (50¢ per unit times 1000 inbound units). The cost to Blue of delivering the international mail from Red is \$250 (500 [30] units at 50¢ per unit). Blue's total cost of international mail also includes the \$125 of terminal dues it must pay to Red because it sends 500 more units to Red than it receives (500 units at 25¢ per unit). Thus, Blue's total cost of international mail service is \$375 and it must charge 37.5¢ per unit (because it sends 1000 units) to recover its costs. Red's total cost of international mail is its actual cost of \$500 minus the \$125 in terminal dues payments from Blue. Consequently, it must earn \$375 on the 500 units of mail it sends out of the country and international postage must be 75¢. As in Example One, remailers may have an artificial advantage since they pay only 25¢ per unit terminal dues plus the incremental costs of transshipping via Yellow.

Example Four: Terminal Dues Above Cost and Mail Flow Imbalance

When terminal dues are above cost, postal administrations have an artificial advantage even when Blue sends more mail to Red than Red sends to Blue.

³² Yellow's cost is the terminal dues rate regardless of the mail flow between Yellow and Blue. If Yellow sent more mail to Blue than it received, Blue would charge Yellow 25¢ in terminal dues for an additional unit. If Yellow received more from Blue than it sent to Blue, Blue would pay Yellow 25¢ less in terminal dues for an additional unit of mail.

Red and Blue incur actual costs of 50¢ per unit in delivering inbound international mail. Terminal dues are \$1.00 per unit. Red sends 600 units of mail to Blue. Blue sends 1000 units of mail to Red. The total cost to Red of delivering international mail from Blue is \$500 (50¢ per 1000 inbound units and no need to pay terminal dues). Blue has total inbound delivery costs of \$300 (50¢ per 600 units) and must make terminal dues payments to Red of \$400 (\$1.00 on each of the 400 more units it sent to Red than it received). Blue's cost of international mail service thus is \$700, and it must charge 70¢ per unit to cover the cost of sending the 1000 units to Red. Red's actual delivery costs of \$500 are partially covered by the \$400 terminal dues payment it receives from Blue. It can recover the remaining \$100 by charging 17¢ for each of the 600 units going to Blue. Remailers with terminal dues costs of \$1.00 per unit would be at an artificial disadvantage against the postal administrations of both Red and Blue.

Example Five: Terminal Dues Above One Country's Cost and Below Another Country's Cost

When terminal dues are above Red's cost, but below Blue's cost, remailers have an artificial advantage taking mail from Blue to Red and are at an artificial disadvantage taking mail from Red to Blue.

Red's cost of completing delivery of international mail is 50¢ per unit. Blue's cost of completing delivery of international mail are \$1.00 per unit. Terminal dues are 75¢ per unit. Red and Blue send each other 1000 units. Red's cost of international mail service is \$500. Blue's cost is \$1000. Neither receives or pays terminal dues. Red must charge 50¢ per unit and Blue must charge \$1.00. Remailers, on the other hand, have costs of 75¢ per unit, above Red's, but below Blue's. [32]

Example Six: Terminal Dues Above Cost for Some Units of Mail and Below Cost for other Units

When the terminal dues rate fails to distinguish between types of mail for which the cost of completing delivery varies, postal administrations can get an advantage unrelated to efficiency in carrying some types of mail and remailers can get an advantage unrelated to efficiency in carrying other types of mail.

Assume that Red and Blue both have costs of 25¢ per unit for completing delivery of LC and costs of \$1.00 per unit for competing delivery of AO. Terminal dues are 50¢ per unit. Blue and Red each send 500 units of LC and 500 units of AO to the other. Since the mail exchange is in balance, neither country pays or receives terminal dues. Each country's cost of international mail is the cost of delivery of the inbound mail, or \$625 (25¢ per unit of LC times 500 units equals \$125; \$1.00 per unit of AO times 500 units equals \$500; \$125 + \$500 - \$625) and they must charge an average price of 62.5¢ per unit. Remailers charge their cost of 50¢ plus marginal and incremental costs of transshipment for every unit of LC and AO. Red and Blue could charge their average cost of 62.5¢ for every unit. If they did, however, they might be unable to compete with remailers. Instead, they could charge prices that more accurately reflect costs: 25¢ per unit for LC and \$1. \$1.00 per unit for

AO. If they did, the remailers price of 50¢ would be below Red's and Blue's \$1.00 charge for AO and above Red and Blue's 25¢ charge for LC. The result would be that remailers would capture the AO market and [33] lose the LC business, in each case for reasons unrelated to efficiency.

The Effect of Weight and Exchange Rates
on Cost and Terminal Dues

Average Weight Per Piece	.76 oz.(1)	1.0 oz.	1.29 oz.
Avg. attributable cost per piece	13¢	17.1¢	22¢
Avg. institutional cost per piece at USPS markup(2)	8.2¢	10.7¢	13.8¢
Avg. total cost per piece at USPS mark-up(2)	21.2¢	27.8¢	35.8¢
Avg. total cost per piece at PRC mark-up(3)	16¢	21¢	27¢
Terminal dues per average piece at 3/2/88 exchange rate	19.3¢	21.2¢	22.5¢
Terminal dues per average piece at USPS exchange rate(4)	n.a.	n.a.	20.8¢
Terminal dues per average piece at 12/31/87 exchange rate	20.1¢	22.1¢	23.5¢

Note: This table is based upon USPS cost calculations

(1) .76 oz. is the average weight of outbound LC, according to USPS data.

(2) The "average" rate was calculated by USPS for a 1.29 oz letter at the average exchange rate of the last twelve months. We do not know the exact rate they used or how they arrived at that rate.

(3) The "USPS mark-up" of 1.62 was applied by Assistant Postmaster General Thomas Leavey in his February 26, 1988 letter to Carol Crawford.

(4) The "PRC markup" is that used by the Postal Rate Commission in its Recommended Decision of March 4, 1988. See Appendix G. Schedules 1 and 3.