June 29, 2006

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VICE PRESIDENT, NETWORK OPERATIONS MANAGEMENT

SUBJECT: International Mail Air Transportation Rates
(Report Number MS-WP-06-002)

The attached white paper describes the regulation of international mail air transportation rates (Project Number 06YS005MS000). The Postal Service spends over $200 million annually to transport international mail, at rates mostly set by regulation, not the market. Evidence suggests that the Postal Service pays more than it would on the open market.

The paper includes appendices that provide additional background information on the details and history of Department of Transportation regulation in this area, cost data and estimates, and stakeholders' views.

We appreciate the cooperation and courtesies your staff provided. If you have any questions, please contact me at (703) 248-2300.

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Attachment

cc: Steven R. Phelps

International Mail Air Transportation Rates

Introduction

The U.S. Postal Service buys most of its transportation from private sector carriers. In fact, it is one of the largest purchasers of transportation in the United States. The Postal Service spent $5.4 billion on purchased transportation in fiscal year (FY) 2005. Generally, the Postal Service contracts freely with its transportation suppliers. Rates are negotiated or determined through competitive bids. International air transportation rates, however, are an exception.[1] The Department of Transportation (DOT) sets air transportation rates for most outbound international and military mail.[2] Additionally, the Postal Service is required to use U.S.-flag carriers where available. The Postal Service has repeatedly called for the deregulation of international mail air transportation rates. It wants the freedom to contract competitively on the open market.

The U.S. Postal Service Office of the Inspector General (OIG) has analyzed the issue. We believe deregulation of international mail air transportation rates could benefit the Postal Service. It already has the flexibility to contract for most of its transportation needs. The exception for international mail is unnecessary and hampers the Postal Service's ability to compete in the highly competitive market for outbound international mail.

In this paper we briefly discuss the current regulation of air transportation for international and military mail and describe how this regulation unfairly burdens the Postal Service. We discuss the benefits of deregulation. We also comment on the Postal Service's alternate proposal for rate flexibility: regulatory forbearance by the DOT.

Outbound International and Military Mail

The DOT typically updates international mail rates once a year, applying a methodology established in the late 1970s. Using cost data submitted by the air carriers, the DOT calculates the change in the carriers' costs from the previous period and adjusts the rates accordingly. Appendix 1 provides a detailed description of the rate-setting process.

The Postal Service spent $211.5 million on international mail air transportation in FY 2004.[3] While this was only a small fraction of total transportation spending, it accounted for a sizeable share of total international mail costs. Payments for

[1] Rates for air transportation within Alaska are another.
[2] 49 USC 41901(b). Military mail is defined as domestic and international mail which bears a military address or return address and that, at some stage in its transmission, is in the possession of the Department of Defense. This paper concerns military mail sent from the United States at domestic rates to overseas military addresses.
[3] At present, FY 2004 is the most recent year for which we have detailed data.

international air transportation alone represented more than 20 percent of outbound international mail costs in FY 2004 or roughly 25 cents per outbound mail piece. In addition, the air transportation of military mail cost $358.0 million in FY 2004. Since the Department of Defense (DOD) reimburses the Postal Service for military mail transportation, taxpayers are responsible for this expense.

Although most international and military mail travels at DOT rates, the Postal Service has limited freedom to negotiate contracts. It can arrange for contracted transportation when there is insufficient capacity on a route.[4] Also, an exception permits the Postal Service to contract for shipments that include primarily non-letter mail and that meet minimum size requirements.[5] Mail sent using this exception accounted for only 7 percent of FY 2004 international mail air transportation costs. Appendix 2 provides FY 2004 air transportation cost and weight information.

Regulation Unfairly Burdens the Postal Service

The DOT's regulation of air transportation rates and the requirement that the Postal Service use U.S.-flag carriers prevent the Postal Service from receiving the best service at the best price. Under the current system the Postal Service allocates mail among participating carriers rather than negotiating the terms and conditions of service. Air carriers have a duty to carry mail and may have to turn away freight shipments when faced with unexpected mail volumes. There is little incentive for the parties to find mutually beneficial efficiencies. Containerization and streamlined handling techniques common in freight transportation are generally not used for international air mail. The Postal Service complains that carriers do not always meet service standards.

The Postal Service also believes that the prices set by the DOT are much higher than those it would pay in a competitive market. It offers several anecdotal examples of this regulatory premium. On a pound-mile basis, prices for domestic air transportation, which the Postal Service contracts, are arguably far lower. Outbound international parcels sent using the exception that permits contracting for non-letter shipments also cost much less than they would under regulated rates. The savings exist despite the fact that parcels, which are less dense than letters and therefore require more cubic space per pound, ought to be more costly per pound. Additionally, the Postal Service believes that foreign posts competing with the Postal Service for outbound international mail volumes pay less to transport mail abroad.

[4] 39 USC 5402(c) and (d).
[5] 39 U.S.C. 5402(b). Initially, the Postal Service used this freedom for International Surface Air Lift (ISAL) shipments of bulk printed matter. In 2003 the Postal Service expanded its use of the exception and awarded International Air Transportation (IAT) contracts for international air parcels and Express Mail.

Since DOT rates vary according to the length of a route and contracted rates may depend upon a number of factors including route length and market demand, it is not easy to compare the overall cost of regulated and contracted air transportation. The average cost per pound, however, offers a rough comparison measure. In 2003 the Postal Service submitted the following list of weighted averages in the current DOT proceeding, Docket OST-1996-1629:

“Marginal/incremental” cost/pound =	$ 0.24
Market freight rates/pound =	$ 0.53
Negotiated (USPS contract) rates/pound =	$ 0.73
Current DOT rates/pound =	$ 1.53

Source: Reply of the United States Postal Service to Carriers’ Answers to Its Motion for Convening of Meeting and Continuation of Current Rates

These averages provide a potential range of rates under deregulation. We elaborate on these cost estimates in Appendix 3. Although there is no current, validated estimate of the size of the regulatory premium, no one has suggested that the Postal Service would pay more if given the freedom to contract for international air transportation. The available anecdotal evidence suggests the cost of regulation to the Postal Service is not negligible.

This regulatory premium is particularly damaging to the Postal Service, because the market for outbound international mail is highly competitive. The Postal Service suspended its monopoly in this area in 1986. Many foreign posts have established facilities in the United States to accept outbound international mail. They are not required by law to pay DOT rates or use U.S.-flag carriers and can use these advantages to compete effectively on price. Even the air carriers, the beneficiaries of air transportation regulation, have used foreign posts to send their mail abroad. No doubt they prefer the lower mailing rates available from operators not forced to pay for DOT-regulated air transportation.

Benefits of Deregulation

We believe lifting the restrictions on the Postal Service’s freedom to contract for international mail air transportation will be beneficial. The Postal Service is mandated to operate in a business-like manner. The ability to purchase international air transportation on the open market will help the Postal Service fulfill that responsibility in the area of international mail. In our opinion Congress could extend the pricing and operational flexibility that has existed for 20 years domestically to international air transportation rates. The Postal Service will then be free to negotiate its rates directly with any carrier it deems appropriate.

Deregulating international mail air transportation will achieve two goals: market-based pricing and operational flexibility. Both will promote greater efficiency and effectiveness in air transportation operations for international mail. Market-based rates can reflect the cost and demand characteristics of particular routes and are not distorted by high-level averaging. Operational flexibility is consistent with business best practices and will yield better service standards and performance if managed correctly. Negotiating operational practices may yield cost efficiencies for both the Postal Service and the air carriers.

Additionally, the available evidence suggests that market rates are lower than regulated rates. As a large customer providing a secure and stable source of income to the airlines, the Postal Service should be able to negotiate favorable terms and prices. Under deregulation international air transportation rates should decline and service should improve. Since the air transportation of outbound mail is a sizeable proportion of total international mail costs, any decline in transportation rates — even a modest one — could reduce the postal rates paid by international mailers. Permitting the Postal Service to contract for international air transportation would also make the Postal Service's international offerings more competitive. Increases in international volume, and thus contribution, would benefit all rate payers. A reduction in military mail transportation costs would also save taxpayers money. The effect of lowering the costs to the Postal Service of international mail air transportation is therefore potentially significant for many parties.

The current system of setting international mail air transportation rates is outdated and inefficient. The present methodology is nearly 30 years old and was developed while Congress was debating the Airline Deregulation Act. It is highly unlikely that this methodology accurately reflects the costs of international mail transportation in today's market. Even a revised and completely appropriate cost-based methodology would not necessarily produce efficient rates. Cost-based rates do not take into account different levels of demand for cargo space. Although passenger carriers oppose deregulation, most stakeholders including the Government Accountability Office, the DOD, the cargo carriers FedEx Express and United Parcel Service, and mailers favor change. (Appendix 4 is a summary of stakeholders' views.) Under deregulation there would be no obligation that carriers transport mail. Each carrier would have the option of negotiating prices to its advantage and rejecting prices that were not.

Regulatory Forbearance: A Second-Best Alternative

Both the House and Senate reform bills included provisions deregulating international mail air rates when they were introduced, but the provisions were removed before the bills passed.[6] It is now highly unlikely that the Postal Service will achieve deregulation through postal reform. On April 14, 2005, the Postal

[6] H.R. 22 and S. 662. The bills are currently awaiting conference.

Service proposed that the DOT adopt a policy of regulatory forbearance and initiate a rulemaking to that end.[7] Under regulatory forbearance the DOT would permit the Postal Service to negotiate rates with the carriers subject to DOT approval. A policy of regulatory forbearance would achieve many of the aims of deregulation; however, it is a second-best alternative. The DOT would still have the ultimate rate-setting authority over international air transportation rates. Some participants in the DOT proceeding have challenged the proposal that the DOT can set rates by reviewing rates negotiated or solicited by the Postal Service. The best solution is for Congress to deregulate international air transportation rates.

Conclusion

The OIG believes regulation of international mail air transportation rates and requirements that the Postal Service use U.S.-flag carriers are vestiges of an earlier age of regulation.[8] They are economically inefficient, and most stakeholders oppose them. Regulation unnecessarily raises costs for both postal rate payers and taxpayers. The Postal Service should be free to purchase international air transportation the way it purchases any other form of transportation. If complete deregulation is not possible, we believe the Postal Service could achieve a more limited solution by encouraging the DOT to adopt a policy of regulatory forbearance.

[7] The Postal Service submitted its proposal in response to the DOT's request for comments on conducting a new base-rate investigation. If DOT decided against initiating a rulemaking to implement regulatory forbearance, the Postal Service proposed in the alternative a full-blown rate case to revise the methodology for determining international mail air rates.
[8] For a brief history of the regulation of air mail transportation rates, see Appendix 5.

Appendix 1: Department of Transportation Rate-Setting

The Rate-Setting Process

There are two components of the DOT regulated rates for international air transportation: a linehaul charge per billing ton mile and a terminal charge per pound originated. The linehaul charge varies by both weight and distance. The terminal charge compensates carriers for costs unrelated to operating the aircraft, such as ground handling, and varies only by weight. The DOT determines rates using a methodology initially established in 1978 and revised in 1979 and 1980 after a protracted rate case by the Civil Aeronautics Board (CAB).[9] The rates are cost based, set using data provided by the carriers to the DOT as part of required filings. Costs are averaged within four regions — Transborder, Transatlantic, Transpacific, and Latin America — and the averages for each region only include data from carriers operating to those regions. Additionally, the DOT sometimes excludes or adjusts a carrier's data if it is inconsistent with previous submissions or information from other carriers. Separate rates are developed for Priority/Military Ordinary Mail (MOM) and Space Available Mail (SAM).[10]

Since 1999 the rate adjustment process has typically occurred annually. The DOT uses the carrier data for the year ending June 30 and proposes rates for the next calendar year. Parties have an opportunity to object to the proposed rates, so it is not always possible to finalize new rates before January 1. In such circumstances the previous rates remain in use, or the DOT can establish interim rates and apply the final rates retroactively. The purpose of the adjustment process is to update the base rate created by the original methodology for inflation. No changes are made to the methodology itself.

Recent Developments

In December 2003 the Postal Service proposed that the DOT postpone updating the rates and authorize a meeting of all parties to discuss alternative rate methodologies. The Postal Service believed a new methodology would result in lower rates. The parties met in May 2004 and established a working group, but they were unable to reach an agreement on a new methodology. On March 15, 2005, the DOT issued proposed rates for 2005 and at the same time requested comments on conducting a new base-rate investigation. The DOT also suggested some changes to the adjustment process. There was mixed response to the idea of conducting a new base-rate investigation. The Postal Service

[9] The DOT inherited the CAB's responsibility for setting international mail rates following the CAB's sunset on December 31, 1984.

[10] There are three types of military mail. Priority includes categories such as Express, First-Class, and Priority Mail. MOM is official Department of Defense mail sent at Periodicals, Standard Mail, or Package Services rates. SAM includes publications and parcels sent to military personnel. The DOT rates for Priority and MOM are the same.

suggested the DOT initiate a rulemaking to implement a policy of regulatory forbearance. As an alternative, it supported a new base-rate investigation.

The DOT issued an order finalizing the 2005 rates in August of that year. The order, however, did not address the proposals for a base-rate investigation or regulatory forbearance. The DOT noted that these were still under review. In September 2005 the Postal Service filed a motion requesting an expedited decision on its proposal for a rulemaking on regulatory forbearance. It also requested that the DOT refrain from issuing 2006 rates. The passenger carriers generally opposed the Postal Service's request, although FedEx Express, United Parcel Service (UPS), and mailer groups supported it. The DOT has neither responded to the Postal Service's motion nor proposed new rates for 2006. In May 2006 the DOD declared its support for regulatory forbearance. Additionally, the passenger carriers requested that the DOT promptly begin the 2006 rate update. UPS and the Postal Service asked instead that the DOT respond to the Postal Service's motion for regulatory forbearance.

Appendix 2: International Mail Air Transportation Cost and Weight Data

The table below shows the cost, weight, cost per pound, and cost share of the international and military mail transported in FY 2004. The cost of transporting mail from the United States to military addresses abroad was $358.0 million. The DOD reimburses the Postal Service for this expense. The cost of transporting

FY 2004 Cost and Weight Data

	Cost	Weight (lb)	Cost per Pound	Cost Share
International Mail (Civilian)				
Air Mail				
U.S. Carriers	$ 164,342,037	113,239,290	$ 1.45	77.7%
Foreign Carriers	$ 32,381,997	25,458,793	$ 1.27	15.3%
Subtotal	$ 196,724,034	138,698,083	$ 1.42	93.0%
Contracted (ISAL & IAT)*				
U.S. Carriers	$ 12,711,346	24,676,339	$ 0.52	6.0%
Foreign Carriers	$ 2,022,648	3,681,862	$ 0.55	1.0%
Subtotal	$ 14,733,994	28,358,201	$ 0.52	7.0%
Subtotal Civilian	**$ 211,458,028**	**167,056,284**	**$ 1.27**	**100.0%**
Military Mail				
Air Priority				
U.S. Carriers	$ 255,105,242	181,177,524	$ 1.41	71.3%
Foreign Carriers	$ 66,521,823	68,616,960	$ 0.97	18.6%
Subtotal	$ 321,627,065	249,794,483	$ 1.29	89.9%
Military Ordinary Mail				
U.S. Carriers	$ 1,742,539	1,447,663	$ 1.20	0.5%
Space-Available Mail				
U.S. Carriers	$ 23,501,096	23,063,318	$ 1.02	6.6%
Foreign Carriers	$ 11,085,324	14,080,250	$ 0.79	3.1%
Subtotal	$ 34,586,419	37,143,567	$ 0.93	9.7%
Subtotal Military	**$ 357,956,024**	**288,385,714**	**$ 1.24**	**100.0%**
Grand Total	**$ 569,414,052**	**455,441,997**	**$ 1.25**	

* Includes mail sent under International Surface Air Lift (ISAL) and International Air Transportation (IAT) contracts. These contracts make use of the exception in 39 U.S.C. 5402(b).

Source: U.S. Postal Service data.

civilian international mail was somewhat less at $211.5 million. U.S.-flag carriers received 84 percent of the compensation the Postal Service paid for civilian international mail transportation. Foreign-flag carriers received the remaining 16 percent.

The Postal Service can contract transportation for shipments that are at least 750 pounds and contain no more than 5 percent letters because of an exception in the law.[11] The Postal Service paid $14.7 million to transport mail using these contracts in FY 2004, and they accounted for 7 percent of civilian international mail air transportation costs. The average cost per pound of mail sent under the exception was only 52 cents. In contrast, the cost per pound of transporting the remaining 93 percent of air mail, which travels mostly at regulated rates, was $1.42.[12]

[11] 39 U.S.C. 5402(b). The contracts are known as ISAL and IAT contracts. The Postal Service uses them to transport bulk printed matter, air parcels, and Express Mail.
[12] We calculated the average cost per pound for mail sent under ISAL and IAT contracts and for the remaining civilian international mail using Postal Service data for FY 2004. In the body of the paper and Appendix 3, however, we use the average rates per pound provided to the DOT docket in 2003. These figures offer better comparability to the other averages listed by the Postal Service.

Appendix 3: Cost Estimates for Calculating the Regulatory Premium

There is no current, validated estimate of the premium the Postal Service pays due to the regulation of international mail air transportation rates. Even if there were, such an estimate could never be exact. There is no way to predict the specific prices the Postal Service would pay if rates were subject to negotiations. Market demand as well as costs would influence rates, and rates might vary according to individual origin-destination pairs. It is possible, however, to get some sense of the amount the Postal Service would pay under deregulation by looking at the average rates in the table below.

Range of Estimated Rates

Category	Average Rate per Pound*
DOT Regulated Rates • Based on regulation from another era. • Very likely that these rates exceed market rates — perhaps significantly.	$1.53
Negotiated Contract Rates • Based on limited areas where Postal Service can contract for international air transportation. • These could be in the range of market rates, but improved containerization may lower costs. • Includes non-letter mail, which is usually less dense. Typically, denser freight costs less, because it occupies less space. Negotiated rates for letters may be less.	$0.73
Freight Rates • Based on established rates for freight. • These could be in the range of market rates, but are likely understated due to schedules, containerization, and destinations of freight (urban centers vs. industrial areas) relative to mail.	$0.53
Marginal/Incremental Cost Rates • Based on questionable costing methodology. • Very likely that these rates are below market rates — probably significantly.	$0.24

Possible Market Rates

* Source:
Reply of the United States Postal Service to Carriers' Answers to Its Motion for Convening of Meeting and Continuation of Current Rates (December 30, 2003), Docket OST-1996-1629.

The Postal Service presented this list in 2003 as part of its efforts to open discussions with the air carriers in the DOT docket. The average rates range from $1.53 per pound for DOT rates to an estimated 24 cents per pound under a so-called "marginal/incremental" cost approach to rate setting. Market-based rates would likely fall somewhere within this band.

Marginal/Incremental Cost Rates: 24 cents per pound

The Postal Service argued that rates set according to a "marginal/incremental" cost approach might be only one-fifth of the then current DOT rates. The cost approach the Postal Service proposed is not consistent with the terms it uses and violates the Postal Service's own cost attribution methodologies. Additionally, 24 cents per pound is far lower than average market freight or negotiated rates. It is highly unlikely the Postal Service could reduce its air transportation costs so much by contracting in the free market.

Freight Rates: 53 cents per pound

Freight rates are more likely to approximate the rates the Postal Service would pay under deregulation. Negotiated air transportation rates for mail might be higher, however, because the terminal handling process for mail is more complex and, thus, more costly than that for freight. The traffic patterns for mail and freight also differ. Mail travels to population centers whereas freight tends to travel to industrial areas. The ultimate effect of these traffic patterns depends on the demand for cargo space. The Postal Service's load factor analysis by region showed that on average lack of capacity is not an issue on most flights. Moreover, mail occupies a small fraction of cargo space. This suggests that other shippers' demand for capacity would not unduly raise market rates.

Contracted Rates: 73 cents per pound

The Postal Service already contracts air transportation for some shipments of bulk printed matter and parcels. The average rate presented for these shipments is 73 cents per pound, higher than the average freight rate. The Postal Service tenders shipments under some of these contracts in containers, so market rates under deregulation might be higher yet if the handling processes for regular shipments remain the same. Improved containerization could lower rates. Shipments eligible for contract rates can include only a small percentage of letters. Market rates for letter shipments might be lower because of their higher density. Carriers usually charge less for denser items, since they occupy less space.

Regardless of whether rates under deregulation are closer to freight rates or the contracted rates the Postal Service currently negotiates, it is highly unlikely they would be as high as DOT rates. The passenger carriers would likely welcome deregulation if they believed it would increase the prices they could charge.

Previous Estimates of the Regulatory Premium

There have been some previous estimates of the regulatory premium. The section-by-section analysis of the 2004 House version of the postal reform bill (H.R. 4341) gave $40 to $50 million as the estimated value of the annual savings from deregulation, but this figure dates at least to 1999 and cannot be verified. The Postal Service also calculated that implementing its “marginal/incremental” cost methodology would have saved it $145 million in calendar year 2003. Finally, Postmaster General John E. Potter, in testimony before Congress in 2004, estimated that deregulating international air transportation rates would save the Postal Service about $100 million annually. Given the variety of estimates, it would be useful if the Postal Service produced a current, transparent, and analytically sound estimate of the premium it pays for international mail air transportation.

Appendix 4: Stakeholders' Views

Written documentation of stakeholders' views concerning deregulation is limited. Permitting the Postal Service to contract international mail air transportation was on the periphery of the central issues of postal reform, and the provision aroused little public comment during hearings on previous versions of the reform bills. Many stakeholders, however, have expressed their views on the Postal Service's proposal for regulatory forbearance in the current DOT international mail rate docket (OST-1996-1629).

Postal Service

Deregulating international air transportation was included as an efficiency-based strategy in the Postal Service's April 2002 *Transformation Plan.* The Postal Service reiterated its intent to pursue contracting freedom for international air transportation in the 2005 Comprehensive Statement. It has also proposed that the DOT adopt a policy of regulatory forbearance. Regulatory forbearance would allow the Postal Service to negotiate with carriers subject to the DOT's approval.

The Postal Service believes that it pays an unnecessary premium under the current rate-setting process. It also complains that the level of service provided by carriers under the current system is sometimes inadequate. The Postal Service believes freedom to negotiate and to use foreign-flag carriers would bring it better prices and better service. To the carriers' arguments that the current prices are justified by the boarding priority necessitated by the statutory duty-to-carry requirement, the Postal Service responds that it would willingly give up this statutory privilege. It has, however, negotiated boarding priority as part of its domestic contracts.

Passenger Carriers

There has been little public comment by passenger carriers on legislative deregulation, although it is believed the passenger carriers were instrumental in removing the deregulation provisions from the 2005 House and Senate postal reform bills.[13] The Government Accountability Office (GAO) described comments it received from three passenger carriers as part of its 2005 report on international mail air transportation.[14] The three passenger carriers opposed the proposed changes then found in the Senate bill. They argued that removing the preference for U.S.-flag carriers would unfairly benefit foreign carriers, since a clause promoting reciprocity with foreign countries could not assure U.S.-flag

[13] The deregulation provisions were removed from both H.R. 22 and S. 662 before the bills were reported out of committee.

[14] Government Accountability Office. *International Mail Air Transportation: Proposed Changes to the Ratesetting Process,* GAO-05-529R. April 8, 2005.

carriers adequate access to foreign markets. They also stated they would suffer competitive harm, since some foreign carriers received subsidies from their governments. One carrier complained that foreign-flag carriers had not been required to make the same investments in facilities and equipment as U.S. carriers and foresaw that U.S. carriers would lose revenue if the proposed changes were adopted. This carrier believed mailers would not receive better service even if air transportation rates decreased. The passenger carriers also expressed concerns about unfair and inconsistent Postal Service contracting practices for domestic mail air transportation. The carriers did not believe current purchasing regulations adequately protected against breach of contract by the Postal Service.

In the current DOT proceeding, Continental Airlines, Inc., Delta Air Lines, Inc., Northwest Airlines, Inc., and United Air Lines, Inc. all filed documents opposing the Postal Service's proposal for regulatory forbearance. They argued that the DOT is required by law to set prices. It had no authority to abandon its regulatory responsibility. Another passenger carrier, American Airlines, Inc. (American), also filed a pleading supporting the current rate-setting process and continued working group discussions. American, however, did not specifically address the legality of regulatory forbearance.

Cargo Carriers

FedEx Express (FedEx) voiced its support for deregulation in documents filed in the DOT's rate docket. The unnamed cargo carrier interviewed by GAO for its report also supported deregulation. This carrier argued that the provisions in the Senate bill would make the international air transportation market more consistent with other deregulated markets and should result in more efficient, market-based rates. In the DOT proceeding, cargo carriers FedEx and UPS both backed the Postal Service's proposal for regulatory forbearance. They argued it was a step towards achieving more market-based rates.

Department of Transportation

According to the GAO's report, the DOT did not take a position on the proposals for deregulating international air transportation rates found in the early versions of the 2005 postal reform bills. In 1999, however, the DOT went on record supporting deregulation. It recommended repealing its authority to set international mail transportation rates in the Federal Aviation Administration Authorization bill it proposed to Congress.[15] In its analysis of the bill provisions, the DOT commented that "[t]he 20 years of successful domestic mail operations, coupled with major changes in world aviation, justify termination of the Department's unneeded and costly rate-setting responsibilities in the international

[15] The deregulation language did not become part of the bills reported from committee (H.R. 1000 and S. 82).

arena." The DOT is still considering the Postal Service's proposal for regulatory forbearance.

Department of Defense

The DOD expressed to the GAO an interest in sharing in any cost reductions and service improvements resulting from international air transportation deregulation. The DOD also sent a representative to participate in the 2004 working group discussions, in which parties to the DOT proceeding attempted to find a new rate-setting methodology. The cost of air transportation for military mail has more than tripled between FY 2002 and FY 2005.

In May 2006 the DOD filed a pleading in support of the Postal Service's request for regulatory forbearance. Based on its contracting experience, it found the DOT rates excessive. The DOD stated that introducing market rates through regulatory forbearance could save it between $50 million and $100 million. It urged the DOT to take prompt action on the Postal Service's motion.

Mailers

Both the Association of Postal Commerce (PostCom) and the Direct Marketing Association have indicated their support for regulatory forbearance. In its filings PostCom commented that its members must pay more for postal services, because the Postal Service is paying too much international mail air transportation. It argued that these higher rates hurt both international and domestic mailers.

Government Accountability Office

In its April 8, 2005 report to Senator Collins, the GAO concluded that the provisions to deregulate international air transportation then found in S. 662 were consistent with the reform principles of flexibility, fairness, and efficiency. According to the GAO, giving the Postal Service the flexibility to negotiate with carriers might make the contracting system more efficient and might provide for more efficient transportation rates, rates that accurately reflected costs. The GAO pointed out that the Senate bill also included provisions to ensure fairness and consistency in contracting practices.[16] The GAO, however, did note that it had not conducted an examination of Postal Service contracting practices with respect to the passenger carriers' concerns.

[16] Section 1004, which states the sense of Congress that the Postal Service should ensure the fair and consistent treatment of suppliers and contractors, remains in S. 662 as passed by the Senate.

Appendix 5: History of the Regulation of Air Mail Rates

Air mail played an important role in the development of the aviation industry in the United States. Starting in 1918, the Post Office Department ran its own air mail service and contributed greatly to the improvement of aviation infrastructure by building beacons and lighted landing fields. When the 1925 Kelly Act permitted the Post Office Department to contract with private carriers, it used this authority to aide the development of the commercial airline industry. Walter Folger Brown, Postmaster General from 1929 to 1933, worked actively to promote the consolidation of the industry to a few large, well-funded companies capable of offering expanded passenger service. Eventually, this unofficial system of regulation gave way to a more formal regulatory regime in 1938. Except for the first year, from 1918 to 1938 the Post Office Department paid more for the transportation of air mail than it received in air mail revenue. This overpayment provided a subsidy to the aviation industry and air mail users.

Under the new regulatory system established in 1938, responsibility for setting passenger, mail, and freight rates moved to the CAB.[17] Mail rates continued to subsidize air traffic until 1953, when the subsidy portion was separated from the air transportation payment and became the responsibility of the CAB. A 1974 CAB study estimated that mail subsidies from 1939 to 1953 totaled $310.9 million.

Despite the CAB's authority to set rates under the Civil Aeronautics Act, the Post Office Department and carriers generally negotiated rates for international mail air transportation, which the CAB then approved. High inflation in the late 1960's and early 1970's caused negotiations to break down, and the CAB opened an international mail rate investigation in 1974. This investigation instituted rates far lower than the ones previously set through negotiation and established the ratemaking methodology currently in use.

The CAB's regulatory authority persisted until the late 1970's, when cargo and passenger service was deregulated. The Airline Deregulation Act of 1978 provided for the Postal Service eventually to receive the freedom to contract for domestic air transportation. After the CAB sunset on December 31, 1984, the Postal Service gained this domestic contracting authority. The CAB's authority to set air transportation rates for international mail and within Alaska transferred to the DOT at the same time. When the DOT took over CAB's regulatory functions for international mail, the rate update process continued without interruption.

[17] The Civil Aeronautics Act of 1938 established the Civil Aeronautics Authority, but reorganization in 1940 split the Authority into the CAB charged with regulation and the Civil Aeronautics Administration.