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United States Government Accountability Office
Washington, DC 20548

April 8, 2005

The Honorable Susan M. Collins, Chairman
Committee on Homeland Security
and Governmental Affairs
United States Senate

Subject: *International Mail Air Transportation: Proposed Changes to the Rate-setting Process*

Dear Chairman Collins:

Provisions in the Senate's proposed postal reform legislation, the Postal Accountability and Enhancement Act (S.662 §1002), seek to address longstanding concerns about the Department of Transportation's (DOT) role in setting transportation rates for certain segments of the U.S. Postal Service's (USPS) international mail. Specifically, these rates are what air carriers charge USPS for transporting letter-class and military mail to international destinations. The methodology DOT uses to set these rates was established by the Civil Aeronautics Board (CAB) in a rate proceeding that concluded in the late 1970s. The transportation of this mail is subject to various statutory requirements, such as having DOT set the rates that USPS is to pay to U.S. air carriers for transporting international mail and a duty to carry provision that requires the air carriers to provide facilities and services for transporting this mail. DOT, USPS, and U.S. air carriers have raised concerns about the current rate process, particularly because the rate-setting methodology has not been comprehensively updated since the late 1970s. Some stakeholders view the current rate-setting process as an anachronism in today's increasingly deregulated international mail and transportation marketplace. USPS has stated that this system results in excessive rates, which negatively affects its financial position and impedes its ability to compete in the international postal marketplace. Some U.S. passenger carriers, however, are concerned that eliminating the current system would exacerbate their existing financial difficulties. Although the stakeholders made efforts over the past year to improve the current rate-setting process, they were not able to reach a consensus. The proposed legislation would eliminate DOT's rate-setting authority and allow USPS to negotiate contracts with U.S. and foreign air carriers for its international mail transportation rates and services.

Therefore, to gain a better understanding of the rate-setting process and the potential impact of the provisions in the recently introduced postal reform bill related to setting rates for international mail air transportation (S. 662 §1002 and 1004), our objectives were to (1) describe the current process DOT uses in setting international mail air transportation rates, how the mail transportation market has changed over time, and the possible implications of these market changes for the current rate-setting process; (2) describe applicable S.662 provisions and the key stakeholders' views of these provisions; and (3) assess these provisions against key principles of postal reform—flexibility, efficiency, and fairness. To provide information on the current rate-setting process and the issues raised about this process, we met with various stakeholders; reviewed current legal provisions, legislative history, the President's Commission on the U.S. Postal Service (the Commission) report, and DOT rate-proceeding documents; and analyzed cost, volume, and weight information for certain segments of USPS mail. To describe the provisions related to changing the rate-setting process for international mail air transportation and stakeholder views of these changes, we reviewed the proposed legislation and interviewed USPS officials, DOT officials, and Department of Defense (DOD) officials. We also met with various air carriers that have publicly commented on issues related to the current rate-setting process. These air carriers included representatives from three of the major U.S. passenger air carriers; one U.S. cargo air carrier; and the Air Transport Association, which is a trade organization for certain U.S. air carriers. To assess these provisions, we applied certain principles found in past GAO reports and testimonies and in the Commission's report. These principles are related to the major transformation goals for postal reform legislation and include balancing increased flexibility for USPS to act more like a business with appropriate accountability mechanisms to ensure fairness to customers and competitors. These principles also include enhancing incentives to improve efficiency by utilizing best practices from the private sector. We determined that the data we used from USPS and DOT were sufficiently reliable for the purposes of our review. Our work was conducted from February 2005 to April 2005 in accordance with generally accepted government auditing standards. We requested comments on this report from USPS and DOT, and they provided oral comments to us, which are discussed later in this report.

Results In Brief

DOT's process for setting international mail air transportation rates is based on a methodology that was established by CAB in the late 1970s. The methodology set at that time allocated all the expenses required to transport the mail on the basis of the percentage of mail traffic to total traffic (i.e. mail, passengers, and cargo). DOT's process for annually updating the rates involves air carriers submitting the relevant cost and volume data to DOT, which then incorporates that updated data into the CAB methodology. Over the last few decades, changes have occurred in the domestic and international mail and air transportation markets that have greatly altered the environment in which these services are provided. These changes include deregulation of the airline industry, deregulation of some domestic and international mail transportation rates, increased competition from foreign air carriers, expansion of the global postal marketplace, and changes in the air transportation marketplace. Although changes in the market have moved toward more competition, the rate-setting methodology has not been updated to reflect these changes. DOT and some of the stakeholders have raised concerns about the appropriateness of the current process in light of these changes and the potential implications on rates and services. For example, USPS has stated the system does not provide market-based rates and services; however, the passenger air carriers we met with stated that the rates charged are commensurate with the services provided. Potential implications of these market changes on the current rate-setting process are that the process may not reflect the current costs of transporting mail and may not be consistent with deregulated and competitive air transportation and international mail markets, may not provide sufficient incentives for efficiency gains, and may not reflect or respond to changes in customer service demands. Thus, USPS may not be benefiting from potential cost saving opportunities—USPS stated it may be paying rates that are too high for services that it does not need, its customers, including DOD, may be incurring higher costs than necessary, and the air carriers may be providing services that are not required.

Provisions in the proposed postal reform legislation would end DOT's role in setting rates related to international mail air transportation and grant USPS the flexibility, under certain conditions, to negotiate with both U.S. and foreign air carriers about rates and services to be provided. Section 1004 of this legislation includes congressional guidance that suppliers and contractors be treated fairly and consistently. Section 1002 includes a reciprocity provision under which each contract awarded to a foreign air carrier shall be subject to the requirement that U.S. air carriers be provided the same opportunity to carry mail of the country to and from which the mail is transported and, if different, the flag country of the foreign carrier. DOT has not taken a position on the provisions in the current legislation. However, it has in the past supported legislative proposals to remove DOT from the rate-setting process. Other stakeholders, however, have voiced divergent views of these provisions to change the rate-setting process. USPS supports these provisions because it believes the provisions will result in lower costs for USPS, provide better incentives for service performance, and allow it to better compete in the global market. Likewise, officials we spoke with at DOD stated that, to the extent USPS would benefit from a reduced rate structure, the costs of transporting military mail should also decrease. The cargo carrier we spoke with supported these legislative provisions because it would move the international air transportation market to be more consistent with other deregulated markets, such as the U.S. airline industry, and should result in more efficient, market-based rates. However, the passenger carriers we met with oppose these provisions due to various concerns, such as the potential loss of revenue, concerns that international air and postal markets are not sufficiently competitive, and concerns that USPS could engage in unfair contracting practices.

We found that the provisions related to changing the process for setting international air transportation rates are consistent with key principles of balancing flexibility, efficiency, and fairness that we have identified as being important for transforming USPS so that it can remain viable in the competitive 21st century environment. Similar to what was recommended in the Commission's report, we previously testified that if USPS is provided additional flexibility to act in a more efficient, businesslike manner, this increase in flexibility must be balanced with accountability mechanisms and enhanced oversight to ensure that USPS competes fairly and that postal customers and competitors are protected against undue discrimination.[1] These provisions grant USPS the flexibility to utilize private sector best practices to improve overall efficiencies by allowing it to, among other things, negotiate rates and services with certain U.S. and foreign carriers. Furthermore, other provisions in this postal reform legislation are consistent with the principles of ensuring fairness and consistency. Section 1004 provides congressional guidance to protect contractors, and section 1002 includes a reciprocity provision and a 5-year transition period in which foreign air carriers are restricted in competing for USPS contracts. We are in the process of further reviewing USPS' contracting practices to determine whether additional congressional oversight or other mechanisms may be needed to ensure that an appropriate balance of flexibility, fairness, and efficiency is maintained. In providing oral comments on this report, USPS agreed with the message of our report, while the DOT stated that it has not established a position on the current legislative provisions related to setting rates for international mail air transportation.

Background

The statutory provisions associated with DOT-regulated international mail air transportation vary significantly from those for the transportation of most other domestic and other international mail classes. The transportation rates for these other classes of mail are negotiated and contracted by USPS and the carriers. Table 1 lists the current provisions that apply to the air transportation of international mail.

[1] *U.S. Postal Service: Key Reasons for Postal Reform*, GAO-04-565T (Washington, D.C.: March 23, 2004).

Table 1: Selected Provisions Related to International Mail Air Transportation

Provision	Citation	Description
U.S. air carrier duty to carry mail.	49 U.S.C. §41903	U.S. air carriers must provide the service and facilities to transport international mail tendered by USPS up to the maximum load prescribed by DOT.
DOT's authority to set rates for U.S. air carriers	49 U.S.C. §41901(b)(1)	Requires the Secretary of the Department of Transportation to set reasonable prices that USPS will pay U.S. air carriers to transport international mail.
USPS contracting authority—bulk mail.	39 U.S.C. § 5402(b)	USPS can contract with U.S. air carriers for air transportation of international mail if the contract is for at least 750 pounds of mail per flight, and no more than 5 percent of the mail, by weight, can be letter mail. Contract must be filed with the Secretary of Transportation at least 90 days before its effective date, and the contract will take effect unless it is disapproved by the Secretary at least 10 days before the effective date.
USPS contracting authority—unavailable service.	39 U.S.C. §5402(c)	When USPS determines transportation of mail by aircraft is required between points in foreign air transportation where no U.S. air carrier has been authorized by DOT, USPS may contract with any U.S. air carrier for the transportation of any class of mail. Transportation under these contracts must cease when a DOT authorized U.S. air carrier begins service.
USPS contracting authority—inadequate service.	39 U.S.C. §5402(d)	When USPS determines that service by U.S. air carriers in foreign air transportation is not adequate for its purposes, it may contract under certain conditions with any air taxi for transportation. USPS must cancel the contract when adequate transportation by U.S. air carriers becomes available.
Use of foreign air carriers	49 U.S.C. §41904	USPS can make arrangements with foreign air carriers when it determines that the transport of mail by aircraft to a foreign country is necessary. This authority has historically been used in situations in which U.S. air carrier service is inadequate.

Source: GAO.

The segment of international mail that is subject to rate-setting by DOT does not encompass all of USPS' international mail. The types of international mail that fall under this regulatory structure include letter class and military mail that originates from the United States.[2] According to DOD officials, DOD is obligated by law to use U.S. carriers for the transportation of military cargo, and reimburses USPS for the transportation costs associated with the international air transportation of military mail.[3] Other types of international mail that are not subject to DOT rate-setting include those moved by surface transportation (i.e., trucked to Canada or Mexico) or bulk air shipments whose rates are set through negotiated contracts. Table 2 shows that the volume and weight of USPS international mail subject to DOT air transportation rates in fiscal year 2004 were less than 1 percent of USPS' total mail volume and weight.

[2]There are three types of military mail: (1) Military Ordinary Mail (MOM) that is official military mail, (2) Space-Available Mail (SAM) that is military personal mail, and (3) Military Priority Mail.
[3]49 U.S.C. §40118.

Table 2: Mail Volume and Weight for Fiscal Year 2004

Mail category	Mail volumes (in millions of pieces)	Percent of total mail volumes	Mail weight (in millions of pounds)	Percent of total mail weight
Domestic mail[a]	205,261,930	99.6%	25,055,323	99.1%
International mail-DOT rates	711,566	0.3%	147,838	0.6%
International mail-other	132,248	0.1%	80,787	0.3%
Total all mail	206,105,744	100%	25,283,949	100%

Source: USPS.

[a]According to USPS, all military mail transported overseas is recorded as domestic mail for financial accounting purposes because customers are charged domestic postage rates.

In 2004, USPS spent about $555 million for the international transportation of DOT-regulated mail; of this amount, U.S. carriers were paid $445 million and foreign carriers were paid $110 million.[4] Furthermore, DOD's expense for reimbursing USPS for the costs associated with transporting military mail overseas was $344 million in 2004. Revenues from transporting mail account for about less than 1 percent of total annual operating revenues for U.S. air carriers.

The Current Rate-setting Process and How Changes in the Marketplace May Affect This Process

DOT's process for setting international mail air transportation rates involves gathering operating data from the carriers and annually updating the rates by applying cost adjustment factors to the rate-setting methodology originally established by CAB in the late 1970s. After applying these cost factors, DOT calculates updated rates. These proposed rates are then issued in a show cause order, and interested parties are provided an opportunity to comment on the proposed rates before the rates are finalized in a DOT order.

The rate methodology resulted from a nearly 5-year rate proceeding before CAB in which air carrier groups and USPS differed about the appropriate methodology for allocating costs to the mail (e.g., fuel costs and facility costs). CAB eventually decided upon the fully-allocated cost methodology to be used when calculating rates, set the rates through June 1979, and established a process whereby future rates would be updated on the basis of changes in operating expenses.[5] When CAB was discontinued in 1984 due to deregulation of the airline industry, the responsibility for setting international mail transportation rates was transferred to DOT.

DOT's process for setting international mail transportation rates was not challenged until late 2003 when USPS filed its analysis of international mail

[4]According to USPS officials, the amount paid to foreign carriers does not reflect the amounts paid to them under any code-sharing agreements they have with U.S. carriers. Under these agreements, USPS would pay the U.S. carrier the DOT-set rate for transporting the mail, the mail is transported on a foreign air carrier, and the U.S. carrier pays some portion of their compensation to the foreign carrier.

[5]According to DOT, the fully-allocated cost methodology allocates all the expenses associated with the assets, materials, services, and labor required to transport mail on the basis of the percentage of mail traffic to total traffic—mail, passengers, and cargo.

transportation rates with DOT.[6] According to USPS' supporting analysis, mail rates were substantially overstated when compared with the marginal cost allocation methodology that USPS advocated.[7] USPS also filed a request for all interested parties to meet and strive to reach consensus on a reasonable alternative(s) to the existing rate-setting process. Although some passenger carriers did not oppose the notion of informal discussions, these carriers submitted a report that was conducted on their behalf to refute USPS' analysis that rates are excessive.[8] In March 2004, DOT issued an order directing the parties to engage in informal discussions about possible revisions to the current methodology for determining rates. The order pointed out that DOT recognized that there were inherent problems with the historical update methodology used to project cost increases. An initial workgroup meeting with representatives from DOT, USPS, and U.S. passenger and cargo carriers took place in May 2004. In a subsequent meeting, the parties agreed to strive for more market-based rates that could facilitate more frequent and efficient rate-setting. Little progress was made, however, in alleviating the concerns raised by USPS and the passenger carriers, and the group has since been discontinued.

On March 15, 2005, DOT issued an order requesting comments within 30 days from the interested parties regarding whether DOT should conduct a new rate proceeding, what the procedure for doing so should be, and what methodology should ultimately be applied to determine mail rates. This proceeding could result in the rate-setting process being changed to account for the changes in air transportation and mail markets.

Changes in the Air Transportation and Mail Markets

Significant changes have occurred in the domestic and international mail and transportation markets since the rate-setting process was set in the late 1970s. These changes have greatly altered the environment in which international air transportation services are provided. Air transportation, particularly to international destinations, was relatively limited at the time CAB originally set the methodology; however, significant increases in traffic both within the United States and internationally have changed this market. Furthermore, the international postal marketplace has become more competitive, with many foreign postal administrations operating in the United States. Some of these changes, such as the increases in competition from foreign postal administrations and changes in air transportation, are likely to continue in the future.

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[6] Discussion of International Mail Rate Methodology, Before the Department of Transportation, Office of the Secretary, Washington, D.C.; December 1, 2003 (DOT Docket OST-96-1629).

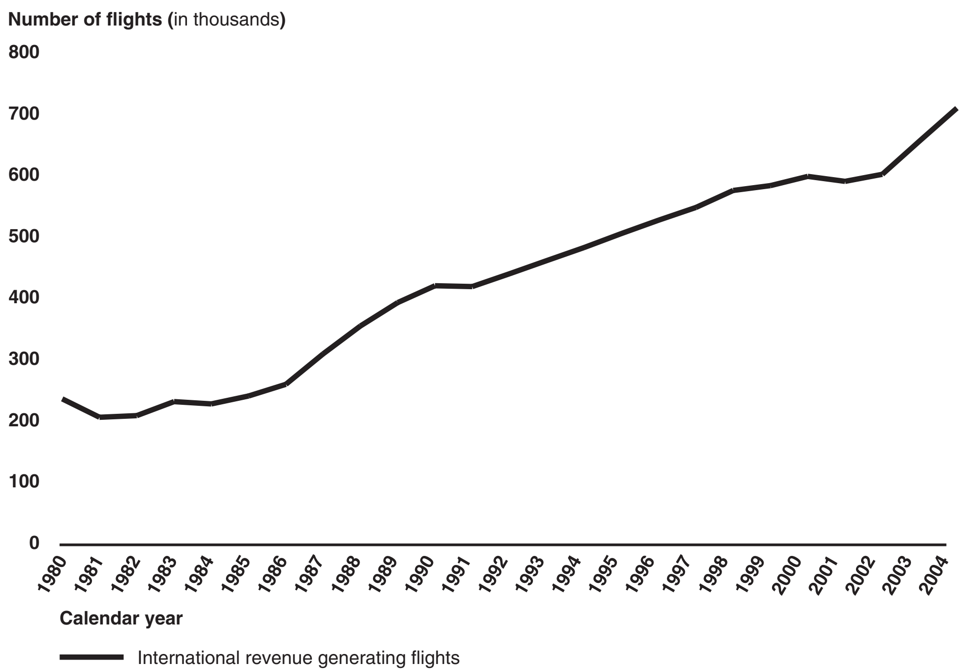
[7] According to USPS, marginal cost allocation methodology reflects the additional costs incurred by carriers for handling and transporting USPS mail, as well as some general and administrative expenses and profit component. Notice of the United States Postal Service of Filing of Supporting Data, Before the Department of Transportation, Office of the Secretary, Washington, D.C.; December 30, 2003 (DOT Docket OST-1996-1629).

[8] Comments on the USPS Proposal and Supporting Analysis Regarding International Mail Rates. Mercer Management Consulting, March 10, 2004, (DOT Docket OST-96-1629).

These changes include:

- Deregulation of the airline industry: The U.S. airline market has been deregulated and become more competitive as U.S. air carriers (both passenger carriers and cargo carriers) serve markets in the United States and internationally. Between 1980 and 2004, the number of revenue-generating flights flown by U.S. carriers within the United States has doubled from over 5.2 million flights to over 10.8 million flights. During this same period of time, the annual number of international revenue-generating flights flown by U.S. carriers has also more than tripled from about 235,000 flights to over 709,000 flights (see Fig. 1). The structure of the U.S. airline industry has also changed due to carrier consolidations and the emergence of regional and low-cost airlines. Although actions, such as the signing of the first Open Skies agreements in 1992, have helped to reduce government restrictions in the international air market, this market is still not as deregulated as the U.S. airline market. For example, some European governments have restricted night-flight operations and have limited U.S. carriers' access to their markets.[9]

Figure 1: Trend in the Annual International Revenue-Generating Flights Flown by U.S. Air Carriers



Source: GAO analysis of DOT data.

- Deregulation of some domestic and international mail air transportation rates: Rate-setting for the air transportation of most domestic mail and certain segments of international mail has been deregulated (see table 3). Currently, less than 1 percent of all USPS mail volume is subject to transportation rates set by DOT. For

[9] GAO, *Transatlantic Aviation: Effects of Easing Restrictions on U.S.-European Markets*, GAO-04-835 (Washington, D.C.: July 21, 2004).

most other domestic and international classes (except for mail transported by air within Alaska), USPS now negotiates with carriers about the prices and services that are to be provided. USPS began contracting the transportation rates for certain bulk international mail in the 1980s and expanded its contracting to include international parcels and Express Mail in 2003.

Table 3: Timeline of Selected Changes to Mail and Transportation Markets

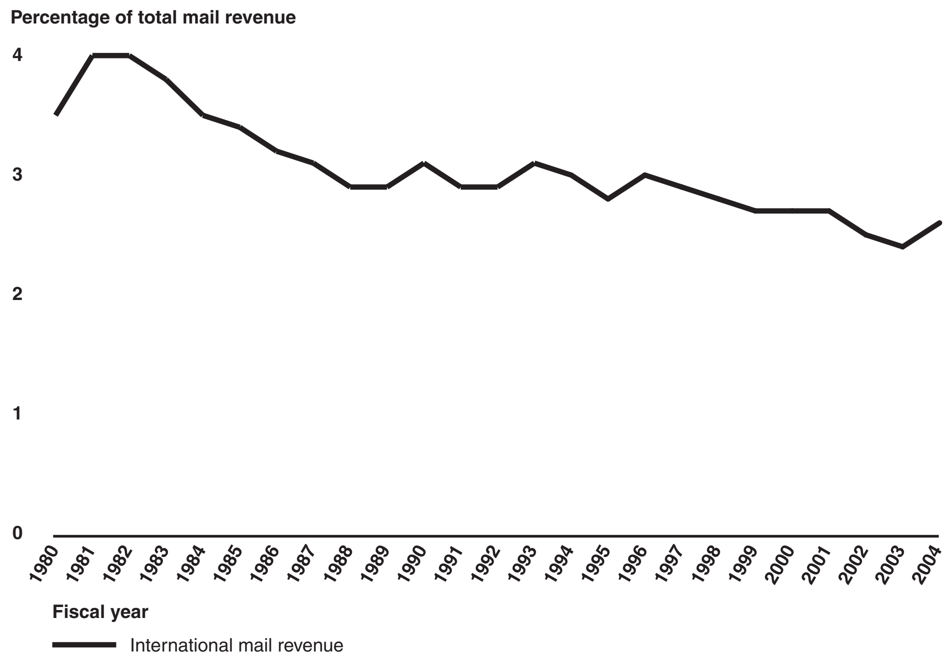
Action	Type of deregulation	Date of action
U.S. airline deregulation: The Airline Deregulation Act of 1978 ended the Civil Aeronautics Board's (CAB) regulation of the airline industry in several phases.	Transportation	1978-1984
USPS contracts for certain international bulk mail: USPS introduces International Surface Air Lift (ISAL) service contracts under which USPS contracts for reduced-rate bulk mailing shipments for certain classes of printed matter such as publications, advertising mail, and catalogs that are offered mailers as a 7- to 14-day service.	Mail	1980
USPS contracts for domestic air mail: Air transportation rates for domestic mail service were deregulated with the sunset of the CAB.	Mail	1984
Move towards deregulating international routes and capacity: United States and foreign countries agree to more "open skies".	Transportation	1980s-1990s
USPS contracts for containerized international mail: USPS introduces the International Air Transportation (IAT) contracts to only U.S. carriers for the transportation in airline containers (rather than in loose sacks) of international air parcels and Express Mail.	Mail	2003

Source: USPS and DOT.

- Increased competition from foreign air carriers: Since deregulation, there has been an increasing international presence of foreign air carriers on routes that originate in the United States. USPS' ISAL contracts, which were initiated in 1980, can include foreign carriers; and as of June 30, 2004, 30 percent of USPS' ISAL contracts were awarded to foreign carriers. In addition to ISAL contracts with USPS, foreign carriers can enter into code-sharing agreements with U.S. carriers, under which the foreign carrier transports USPS' DOT-regulated mail on one of its aircraft. In this instance, USPS pays the international rate to the U.S. carrier, which then pays a portion of this cost to the foreign carrier for the service.

- Expansion of global postal marketplace: The international postal marketplace has expanded, and USPS faces increasing competition from foreign postal administrations. As figure 2 shows, USPS has lost market share in this environment as its international mail revenue as a percentage of its total mail revenue has been decreasing. Several factors have contributed to this change. First, the distinction between the roles of public and private providers of postal services has blurred as the deregulation of postal administrations continues in many foreign countries. For example, the German national postal operator, Deutsche Post World Net, is partially privatized and has expanded globally in Europe and the United States, offering a wide range of international postal products. Second, several foreign postal administrations have set up facilities in the United States that can transport international mail from the United States to a third country without going through USPS.[10] According to USPS, as of March 2005, nine foreign countries were operating 25 such facilities in the United States; and at the end of fiscal year 2004, nearly 20 postal operators have established 100 such facilities worldwide.

Figure 2: USPS' International Mail Revenue Share of Total Mail Revenue Has Been Decreasing

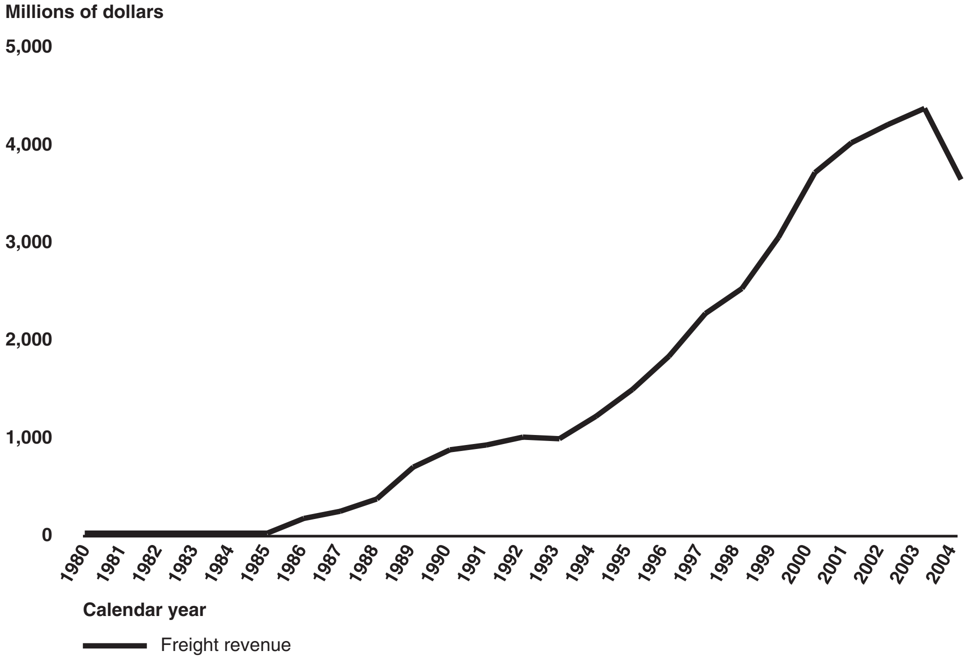


Source: GAO analysis of USPS data.

- Changes in air transportation marketplace: The roles of U.S. carriers (both cargo and passenger) in transporting mail and freight have also changed over time. Since the fall of 2001, security restrictions prohibited U.S. passenger carriers from transporting mail domestically weighing 1 pound or more. As such, USPS has moved most of its Priority Mail and larger mail pieces to a U.S. cargo carrier. Furthermore, since 1980, revenue from transporting freight internationally has increased significantly for the major U.S. cargo carriers to about $3.6 billion in 2004 (see figure 3). This increase was due in large part to the demand for worldwide express and expedited delivery services. In comparison, revenues from transporting freight internationally for the major U.S. passenger carriers were about $1.3 billion in 2004.

[10]These facilities, extraterritorial offices of exchange (ETOE's), are offices that postal operators establish outside of their national territory to process and tender international mail.

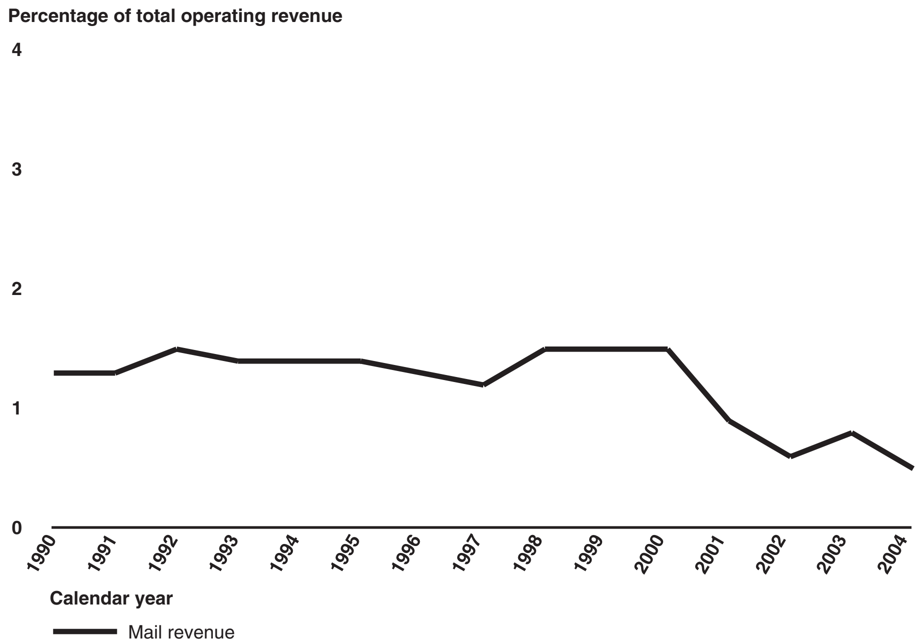
Figure 3: International Freight Revenues For the Major U.S. Cargo Carriers Has Been Increasing



Source: GAO analysis of DOT data.

As freight revenues for these carriers have been increasing, the percentage of domestic carrier operating revenues from mail has decreased (see Figure 4). In regards to DOT-regulated international air mail, however, USPS stated that its costs paid to domestic carriers' for this segment of mail have more than doubled, from $216 million in fiscal year 2000 to almost $445 million in fiscal year 2004.

Figure 4: Mail Revenue as a Percentage of Total Operating Revenue for U.S. Carriers Has Been Decreasing



Source: GAO analysis of DOT data.

Potential Implications of Market Changes on Current Rate-setting Process

Although changes in the market have moved toward more competition since 1978, the rate-setting process has not been updated to reflect these changes. DOT's process for annually updating the rates involves reviewing cost and volume data submitted by the air carriers and incorporating this data into the methodology established by CAB. Some potential implications that may result from using a methodology that has not fully incorporated these changes are that the rate-setting process may not reflect a competitive, efficient, and service-oriented market. Therefore, postal customers, including DOD, may not be benefiting from potential cost-saving opportunities and may be paying higher rates than necessary. Specifically:

- The process is inconsistent with deregulated and competitive markets. According to DOT officials, the system may not reflect current accounting and economic principles. DOT has raised questions about how effectively the update process incorporates changes in carrier costs. USPS has raised concerns that the system is inconsistent with its rate-setting process for negotiating domestic mail transportation rates. USPS believes that its inability to contract for and receive more market-based competitive rates may result in loss of international market share. In addition, the U.S. cargo carrier we met with stated that the current rate-setting process is not needed and expressed concern that the process is unlikely to achieve a true market-based competitive rate. On the other hand, the three passenger carriers we met with raised concerns that some segments of the international transportation market are still not sufficiently competitive. For example, they noted that some foreign governments have operational restrictions, such as limitations on U.S. carrier access to certain routes. They also told us that some foreign governments provide subsidies to their national air carriers, which give these air carriers an unfair advantage in terms of the rates they could charge for transporting mail and cargo. Further, they all had concerns that USPS would unfairly leverage its government mail monopoly when negotiating for international mail transportation contracts. To offset these limitations, these carriers believe that some level of regulation is needed.

- The process does not provide sufficient incentives for efficiency gains. The current statutory requirements and rate-setting process limit the ability of stakeholders to achieve potential efficiency gains. For example, under the current statutory requirements, in order to be eligible to transport the segment of USPS' international mail subject to DOT rate-setting, U.S. air carriers are required to make available the facilities and services necessary to do so. This may result in duplicative costs because USPS already has facilities nearby at many of these departure locations. Furthermore, the current rate structure does not require USPS to submit known volumes or mail in a containerized form—two actions that may result in more efficient mail transportation. These components are typically negotiated between the customer and the air carrier in transportation contracts, particularly for USPS in its domestic mail air transportation contracts. Thus, USPS' ability to provide variable amounts of mail in a noncontainerized manner results in additional costs for the air carriers and higher rates charged to USPS. These cost increases may be directly passed on to international postal ratepayers. The current rate-setting process may also not provide the necessary incentives to air carriers to seek cost-saving approaches (either by actually cutting costs or by reporting lower costs to DOT) because the higher costs they incur and/or submit will be reimbursed through higher rates charged to USPS.

- The process does not reflect customer (USPS) service demands. USPS raised concerns about the quality of service it receives and noted that few incentives exist in the current process for air carriers to provide better quality service. For example, USPS reported that service problems are of a greater concern now because, under new arrangements with foreign postal administrations, USPS can be penalized if service performance standards, such as timeliness of delivery, are not met. USPS also noted that U.S. carriers do not always have schedules that meet mail service requirements or provide sufficient capacity. Further, USPS said that it has only limited methods to correct service issues; and it has to pay rates for some services that it does not need (e.g., priority boarding associated with the duty-to-carry requirement), which results in costs higher than necessary. USPS would prefer rates similar to cargo market rates for similar products and would prefer to be able to negotiate service loads. The passenger carriers stated that they provide services for USPS that are required by law; and because the services are significantly different from what they typically provide other customers, they incur higher costs. These higher costs must be reflected in rates that are higher than the rates some other customers are charged.

The Provisions in the Recent Postal Reform Bill to Change the Rate-setting Process and Stakeholder Views of this Change

Congress has recently proposed making a substantive change in how rates are set for the segment of international mail currently regulated by DOT. Provisions in the recent postal reform bill (S. 662, §1002) would end DOT's responsibility for setting rates and grant USPS the flexibility to negotiate with both U.S. and foreign air carriers under certain conditions about the rates and services to be used in international mail air transportation. Section 1002 would also repeal some of the current service requirements, such as duty to carry for U.S. carriers, and require foreign carriers to be authorized by DOT. Further, it sets forth a "reciprocity" provision which specifies that each contract awarded to a foreign air carrier shall be subject to the requirement that U.S. air carriers be provided the same opportunity to carry mail of the country to and from which the mail is transported and, if different, the flag country of the foreign carrier. Section 1004 provides congressional guidance for USPS to protect contractors and suppliers by ensuring fair and consistent treatment in its purchasing policies. Stakeholders have voiced divergent views of these changes, with USPS and the cargo carrier generally supporting them; the three U.S. passenger carriers we met with strongly opposed them. While DOT has not taken a position on the current legislative provisions, it has in the past supported legislative proposals to remove DOT from the rate-setting process. Table 4 summarizes selected provisions in this legislation related to rate-setting for international mail air transportation rates.

Table 4: Selected Provisions Included in S. 662, the Postal Accountability and Enhancement Act

Citation	Summary provision
S. 662, §1002	USPS may contract rates and service terms with U.S. or foreign air carriers for the transportation of mail by aircraft in foreign air transportation, either through negotiations or competitive bidding, except that: • Contracts can only be awarded to air carriers that are authorized by DOT to provide air transportation. • Mail transported under such a contract is not subject to any duty-to-carry requirement. • USPS cannot contract for service in foreign air transportation or tender mail to or with a foreign carrier or an air carrier in a code-sharing arrangement where the air carrier's code is used to identify a flight operated by a foreign air carrier, for a period of 5 years beginning 1 year after enactment of the proposed legislation, subject to certain exceptions. • Beginning 6 years after enactment of the proposed legislation, every contract that USPS awards to a foreign air carrier shall be subject to the requirement that U.S. air carriers be provided the same opportunity to carry mail of the country to and from which the mail is transported and the flag country of the foreign air carrier, if different, as USPS had afforded the air carrier. • The Postmaster General must consult with the Secretary of Defense concerning actions that affect the carriage of military mail in foreign air transportation.
S. 662, § 1004	Congress wants USPS to ensure the fair and consistent treatment of contractors under USPS purchasing policies and procedures, and to implement commercial best practices in its purchasing policies to achieve greater efficiency and cost savings, as recommended by the President's Commission.

Source: S. 662.

USPS, DOT, and Air Carriers Have Divergent Views of the Proposed Changes to the Rate-setting Process

Stakeholders have voiced divergent views on these potential changes and their implications. USPS and a U.S. cargo carrier generally support the changes to move toward a negotiated, competitive process in contracting for international mail air transportation rates because they feel that this system would result in market-based rates and service. The passenger air carriers that we met with, however, prefer the current DOT rate-setting process. These carriers are opposed to the changes because they have concerns about restrictions on competition that exist in international mail and transportation markets, as well as about USPS' ability to ensure fair and consistent treatment in its contracting practices.

Issues Related to Competition in International Mail and Air Transportation Markets

USPS supports these provisions and would like to establish a competitive contracting environment for this segment of international mail. USPS stated that the proposed changes could address its concerns mentioned previously regarding the current rate-setting process. The officials believe that negotiating rates and services will enhance innovation, provide incentives for improved service performance, and allow USPS to better compete in the global postal marketplace. Specifically, USPS stated that this new rate-setting system will help it to meet its contracting objectives, which include achieving greater service performance, improving document control, and reducing transportation costs. USPS stated that experience suggests that allowing foreign carriers to participate in transportation contracts would stimulate competition and result in lower prices. The U.S. cargo carrier that we met with told us that it also supported the changes because they would establish a competitive contracting process that would likely result in true market-based rates and services. DOT has not taken a position on the current legislative provisions. However, in the past, DOT has supported legislative proposals that would have ended what it characterized as its outdated role in setting rates for transporting international mail. DOD officials we spoke with stated that to the extent that USPS would benefit from a reduced rate structure, the costs of transporting military mail should also decrease. DOD officials also stated that to the extent that USPS would receive equal or better services, DOD would expect to share in that equal or better service.

The passenger air carriers we met with oppose the proposed changes to DOT's rate-setting authority because they believe that some parts of the international mail air transportation market are not competitive enough to ensure market-based competitive rates. These carriers noted that the reciprocity provision would not provide a level playing field for the U.S. carriers or ensure that U.S. carriers have access to foreign markets. They noted that certain international air transportation remains regulated due to flight restrictions, route restrictions, and foreign country restrictions that limit U.S. carriers' ability to fly mail to or from certain foreign countries. These carriers also stated that this proposal would unfairly benefit foreign carriers because there is significantly more outbound USPS mail than incoming mail to the United States from other foreign postal administrations. Another disadvantage they cited that would affect the competitive position of the U.S. airlines in the international air transportation marketplace is that some foreign air carriers are subsidized by their governments. One U.S. passenger carrier, in particular, raised concerns that foreign carriers have not had to make similar capital investments in facilities or equipment to process and transport USPS international mail. This carrier stated that the proposed change would ultimately have three consequences: (1) it would cause U.S. air carriers to lose revenue, (2) more international mail would travel on foreign carriers, and (3) customers would not receive better service even if the international mail rates decrease.

Issues Related to Fairness in USPS' Contracting Practices

The U.S. passenger carriers that we met with also raised concerns about USPS leveraging its monopoly in ways that could result in unfair and inconsistent USPS contracting practices. Specifically, one carrier told us that its concerns have arisen from negative experiences in other areas where USPS has been granted unfettered contracting authority for the domestic transportation of mail. All of the carriers felt that the current processes USPS uses, as outlined in the USPS Purchasing Manual, do not provide adequate protections for the carriers if USPS breaches a transportation contract. These carriers contend that USPS has unilaterally changed the terms of domestic mail transportation contracts.

However, when asked about ensuring fair and consistent treatment under its proposed expanded contracting authority, USPS stated that appropriate competition will be ensured, similar to how it is provided under the competitive contracting for other international mail segments. USPS officials noted that U.S. carriers are still the primary contractors for most of these contracts and that DOT has not disapproved any of the contracts for this type of mail. Further, an air carrier stated that under the proposed changes, if USPS requests for price and service terms are unreasonable, it may not receive competitive bids that could result in lower costs.

Provisions in S. 662 Related to International Mail Air Transportation Rate-setting Incorporate Key Principles

We analyzed the provisions in the proposed postal reform legislation and compared them with key principles of balancing flexibility, efficiency, and fairness that we and the Commission recognized are important when postal reform is considered and found that the proposed provisions are consistent with these principles. We have testified and reported on multiple occasions that we support postal reform legislation that would provide USPS additional flexibility to act in a more efficient, businesslike manner along with appropriate accountability mechanisms to ensure fairness.[11] Similarly, the Commission's report called for USPS to take advantage of corporate best practices to improve overall efficiencies, and stated that in instances where USPS is granted additional flexibility, mechanisms are needed to ensure fairness and transparency in USPS operations.[12] Although we found that the provisions in S. 662 related to setting rates for international mail air transportation are consistent with these key principles, additional congressional oversight may be needed to ensure that a balance of flexibility, fairness, and efficiency is maintained under this new contracting authority.

These provisions in the recent postal reform legislation give USPS the flexibility to utilize private sector best practices to improve overall efficiencies. Flexibility and efficiency are consistent with what we have reported in our prior work and with the Commission's report that USPS needs to increase overall postal efficiencies—both in terms of cutting costs as well as improving service. The additional flexibility granted to USPS to negotiate with carriers (both U.S. and foreign) about rates and services may help to promote a more successful and efficient contracting system—one that balances the current service needs of the customer with rates that reflect the actual costs incurred to meet those needs. To the extent that the proposed change to competitive negotiations helps to drive out inefficiencies in the current system, customers should benefit from paying market-based rates that are commensurate with the services that are being provided.

[11] GAO-04-565T; *Need for Comprehensive Postal Reform*, GAO-04-455R (Washington, D.C.: Feb. 6, 2004); *U.S. Postal Service: Key Elements of Comprehensive Postal Reform*, GAO-04-397T (Washington, D.C.: Jan. 28, 2004); *U.S. Postal Service: Bold Action Needed to Continue Progress on Postal Transformation*, GAO-04-108T (Washington, D.C.: Nov. 5, 2003).
[12] President's Commission on the United States Postal Service, *Embracing the Future: Making the Tough Choices to Preserve Universal Mail Service*, (Washington, D.C.: July 31, 2003).

In addition, the postal reform legislation contains proposals aimed at ensuring fairness and consistency in contracting practices that are consistent with our prior work and the Commission's report. In instances where USPS is granted additional flexibility, this flexibility is coupled with accountability and transparency to help facilitate fair and consistent treatment of consumers and contractors. We have previously stated that postal reform legislation should clarify USPS' mission by defining the scope of the monopoly to ensure that it competes fairly. The legislation should also provide enhanced oversight to protect postal customers and competitors against undue discrimination. The postal reform legislation in section 1004 includes a statement on the sense of Congress that suppliers and contractors be treated fairly and consistently. Section 1004 promotes specific mechanisms, such as competitive contract award procedures, effective dispute resolution mechanisms, and socioeconomic programs, to improve fairness and access to contracting opportunities. Further, section 1002 contains other provisions, such as a 5-year transition period during which foreign air carriers are restricted in competing for USPS contracts, as well as the reciprocity provision. We have not examined USPS contracting practices to determine how the concerns of the passenger carriers we met with related to USPS' contracting practices need to be addressed. We have been asked to review USPS' proposed changes to its contracting procedures and are in the process of determining if further congressional oversight or other mechanisms may be needed to ensure that a balance of flexibility, fairness, and efficiency is maintained.

Agency Comments and Evaluation

USPS and DOT provided oral comments on a draft of this report. USPS agreed with the message of our report, while DOT stated that it has not established a position on the current legislative provisions related to setting rates for international mail air transportation. We also incorporated technical comments from USPS where appropriate.

Scope and Methodology

To provide information on the current rate-setting process, how the international mail air transportation market has changed over time, and the potential implications of these changes, we met with DOT officials and various stakeholders, such as USPS, DOD, the Air Transport Association, three U.S. passenger carriers, and one U.S. cargo carrier. These carriers also participated in recent efforts to improve the current rate-setting process. We also reviewed current legal provisions related to USPS' contracting authority for international air transportation rates subject to DOT; DOT rate-proceeding documents, including DOT orders and submissions from USPS and various U.S. airlines; and the President's Commission on the U.S. Postal Service report. To provide quantitative data on the various segments of USPS mail, we reviewed USPS' periodic reports and financial statements and discussed the specific operating and financial information with USPS officials. USPS officials then supplemented this data with other volume and cost information related to DOT-regulated mail, which we also reviewed with them. The DOT financial and operating data was generated from a database that GAO recently reviewed. On the basis of these efforts, we determined that the data provided to us was sufficiently reliable for the purposes of our review.

To identify the proposed legislative changes to USPS' contracting authority and the views of key stakeholders, we interviewed officials from DOT, USPS, the Air Transport Association, three U.S. passenger carriers, and one U.S. cargo carrier. These carriers have been active in congressional discussions regarding proposed legislative changes in this area. We also reviewed the contents of current and previous postal reform legislation, as well as any pertinent legislative history, committee reports, or DOT and stakeholder comments.

To assess the proposed changes to USPS' contracting authority, we applied certain principles found in past GAO reports and testimonies and in the Commission's report. These principles are related to the major transformation goals for postal reform legislation and include balancing increased flexibility for USPS to act more like a business along with appropriate accountability mechanisms to ensure fairness to customers and competitors. Another key principle is to enhance incentives to improve efficiency by utilizing best practices from the private sector. We conducted our work from February 2005 to April 2005 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Chairman and Ranking Minority Member of the House Committee on Government Reform, Ranking Minority Member of the Senate Committee on Homeland Security and Governmental Affairs, Senator Thomas R. Carper, the Secretary of the Department of Transportation, the Postmaster General, and other interested parties. We will also provide copies to others on request. This report will also be available on our Web site at no charge at http://www.gao.gov.

If you have any questions regarding this report, please contact me at siggerudk@gao.gov or by telephone at (202) 512-2834. Major contributors to this assignment included Teresa Anderson, Joshua Bartzen, and Tonnye Conner-White.

Sincerely yours,

Katherine Siggerud
Director, Physical Infrastructure Issues

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